U.S. DEPARTMENT OF THE TREASURY'S DEBT BUYBACK PROPOSAL

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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WEDNESDAY, SEPTEMBER 29, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
September 22, 1999
No. FC–13

CONTACT: (202) 225–1721

Archer Announces Hearing on Treasury's Debt Buyback Proposal

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on U.S. Department of the Treasury's debt buyback proposal. The hearing will take place on Wednesday, September 29, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include representatives of the U.S. Department of the Treasury, the U.S. General Accounting Office, and other experts in debt management. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Article I, Section 8 of the Constitution gives Congress the power "to borrow money on the credit of the United States." Congress has, therefore, historically been concerned about the level of public debt and the cost to the taxpayer. Originally, Congress approved each Government debt issue. In more recent times, through the statutory limit on the public debt (31 U.S.C. 3101) specified levels of overall debt were authorized, and adjusted when necessary. Congressional oversight of Treasury's debt management policies is essential to ensure the lowest cost of borrowing to the taxpayer given the large scope of public borrowings.

The Congressional Budget Office and the Office of Management and Budget have both forecast sizeable budget surpluses over the next 15 years. Fiscal year 1998 surpluses already have reduced the Government's borrowing needs, causing Treasury to adjust its debt management policies. Last year, Treasury suspended auctions of 3-year notes and reduced the frequency of 5-year note sales.

As large surpluses continue to reduce the Government's borrowing needs, Treasury must consider how its policies will affect taxpayer costs and capital market efficiency. Consequently, Treasury is exploring new debt management polices. On August 4, 1999, Treasury announced regulations (31 CFR Part 375) to allow Treasury to buy back outstanding debt before it matures. In essence, Treasury would buy back old debt and re-issue new debt in its place. Such a policy would not reduce the level of debt, but it may help Treasury achieve other goals, such as improving liquidity and achieving targeted cash balances. A debt buyback program would increase short-term costs, but should generate long-term budgetary savings.

In announcing the hearing, Chairman Archer stated: "With large and growing budget surpluses projected over the next 15 years, we have an historic opportunity to reduce our national debt. As the Administration explores adjustments to its debt management policies, including a new proposal to buy back outstanding debt, the Congress needs to remain engaged in decisions regarding the level of debt and its costs to the taxpayer, as well as the growing debate concerning the efficiency of

global and domestic capital markets. Our goal should be to reduce significantly the national debt at the least cost to the taxpayer."

FOCUS OF THE HEARING:

The hearing explores the potential costs and benefits of Treasury's debt buyback proposal and the effect such a proposal would have on the budget. In addition, the hearing will examine Treasury's debt management goals and the policy issues posed by growing surpluses. Finally, the hearing will review the economic and budgetary effects of Treasury's debt management policies.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the *close of business,* Wednesday, October 13, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, Room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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Chairman ARCHER. The Committee will come to order.

For the first time in over 40 years, the Federal budget will record back-to-back surpluses. These surpluses have allowed us to pay down the debt by $51 billion last year, and it is now projected that we will pay down the debt by over $100 billion this year. This is truly a historic achievement that many of us, even as recently as 2 or 3 or 4 years ago, would not have believed to be possible.

The prospect of large and growing budget surpluses in the future has created a new challenge for the Treasury Department in how the national debt is managed. In August Treasury proposed a new direction for debt management practices. This option would allow Treasury to buy back debt from the public before it matures. That also would have been unthinkable even a few years ago.

As I understand the proposal, Treasury would, in essence, buy back old debt and re-issue new debt in its place. Such a policy would not reduce the level of debt, but it may help Treasury achieve other goals, such as improving liquidity and achieving targeted cash balances. Clearly any change in Treasury's debt management policy could have far-reaching implications for consumers, financial markets, and the economy, and that is why we are conducting this hearing today.

How much will this plan cost in the short and the long term? What will be the impact on the taxpayer? How will the budget surplus be affected? What impact will this have on the markets? And what lessons have other countries learned when faced with a similar challenge? I hope to hear from our witnesses on these and other questions.

In closing, let me say I am proud that we find ourselves in this situation. The Treasury proposal to change debt policy is further proof that there is indeed a budget surplus in Washington, and that we have already paid down billions of dollars in debt. That is, in itself, a tremendous accomplishment that few people ever thought possible only a few years ago.

I now will recognize Mr. Rangel for any comments he would like to make on behalf of the minority, and without objection, each member will be able to insert their written statements in the record at this point.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I want to join with you in welcoming the new Treasury Assistant Secretary Lee Sachs. We congratulate you collectively for your confirmation.

It is good news, as the chairman said, that we come to discuss a new challenge in debt management that arises out of fundamental good news, the fact that the Federal Government has started to run unified budget surpluses, and as a result, we can begin to start to retire Federal debt held by the public. As recently as 1992, the unified deficit was $290 billion. This year the unified budget is likely to have a surplus of about $115 billion. This has been great for the economy, and it also means that we are starting to put resources into the bank for future generations rather than running up balances on the national credit card. It means that we have a historic opportunity to fix the Social Security and fix Medicare and to do it while the sun is shining.

A great deal of this progress has been due to the leadership of President Clinton and Vice President Gore and the very tough votes provided in 1993 by Democrats alone, without the assistance of anyone from the other side. We voted for this historic deficit reduction package and today we are seeing the benefit of such courage.

The Treasury now proposes to buy back outstanding debt. This may be a new technique because I understand that the Treasury needs this tool to carry out the kind of debt management that Treasury has done in the past. When there were deficits, Treasury could manage this mix between long- and short-term Treasury securities by choosing the kind of securities to sell. However, now that there are surpluses, the debt makes this change by the arbitrary nature by which outstanding securities happen to mature; by buying back the actual activity, Treasury can manage their debt mix again.

This is an opportunity for Members of Congress to hear from witnesses who I hope will keep us focused on the fundamentals and steer us away from the misunderstandings that might arise from the complex technicalities of budget accounting and debt management. We hope that Congress will continue to protect these newly found surpluses so that you will be able to use the new techniques in managing debt.

Thank you for being here.

And thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Rangel.

[The opening statement of Mr. Ramstad follows:]

Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for convening this important hearing to examine the Department of the Treasury's proposal to redeem outstanding, unmatured Treasury securities.

Let me begin by noting what a pleasure it is to be discussing this issue. It wasn't that long ago when growing deficits and exploding debt were the norm. Due to a concerted effort at fiscal responsibility, we are moving in a new direction in which growing surpluses are now expected.

Just last year the budget surplus was $69 billion. This week, the President estimated the surplus will be $115 billion in fiscal year 1999. Over the next 10 years, the news gets even better. In fact, the Congressional Budget Office projects that over the next decade, there will be a decline in publicly-held debt to $865 billion, from the current $3.3 trillion.

I'm under no illusion that this will be easily accomplished. It will take a strong effort to maintain this fiscal course. But I think we all agree that the era of deficits is over.

This new path does present some difficult economic issues and today we will explore one of them: redeeming federal debt. In response to the growing surpluses, the Treasury has already stopped issuing three-year notes and the monthly auctions of five-year notes have been reduced to quarterly auctions.

In August, Treasury issued a proposed regulation to begin redeeming unmatured Treasury securities. In theory, this proposal will improve the flexibility and liquidity of the federal government and promises to keep borrowing costs down. But these benefits will come at a direct cost to the Treasury.

In other words, this proposal presents a short-term cost to the bottom line of the federal government with the *promise* of a long-term benefit.

I am anxious to hear from the witnesses today just how much this will cost in the short term and if there are any quantifiable long-term benefits.

Again, Mr. Chairman, thank you for providing us this forum to explore the Administration's proposals in detail.

—

Secretary Sachs, we are pleased to have you here on what is in effect your maiden voyage before this Committee. We welcome you, and we will be pleased to hear your testimony. We hope that you can keep your verbal testimony to 5 minutes, and your entire printed statement would then, without objection, be printed in the record.

Welcome and you may proceed

STATEMENT OF LEE SACHS, ASSISTANT SECRETARY FOR FINANCIAL MARKETS, U.S. DEPARTMENT OF THE TREASURY

Mr. SACHS. Thank you, Mr. Chairman, Mr. Rangel, distinguished Members of the Committee. It is an honor to be here today to discuss Treasury debt management and our proposal to create a mechanism to repurchase outstanding Treasury securities prior to maturity.

Mr. Chairman, I would like to thank you personally and other Members of this Committee for the leadership you have shown on debt management issues. Your role in this area has been extremely helpful to the Department in exercising its debt management responsibilities in a fiscally prudent and nonpartisan manner.

The fiscal discipline of recent years has helped to foster a strong U.S. economy and has led to our first back-to-back budget surpluses since 1956 and 1957. We expect this quarter to pay down $16 billion in privately-held marketable debt, bringing the total reduction to an estimated $100 billion by the end of this fiscal year, and $210 billion for the past 2 years.

Reducing the supply of Treasury debt held by the public has enormous benefits for our economy. It means that less of the savings of Americans will flow into government bonds and more will flow into investment in American businesses. It means less reliance on borrowings from abroad to finance American investment. It means less pressure on interest rates and, thus, lower relative borrowing costs for businesses and American families.

While reducing the debt held by the public greatly benefits the economy, it brings with it significant challenges. As a result of the reductions in publicly-held debt, the ongoing task of debt management for the Federal Government will be very different in the years ahead than it has been in the past when debt was rapidly increasing.

Treasury debt management has three main goals: First, to provide sound cash management in order to ensure that adequate cash balances are available at all times; second, to achieve the lowest cost financing to the American taxpayer; and third, to promote efficient capital markets.

In our efforts to achieve these goals, we seek to maintain, No. 1, the risk-free status of Treasury securities; No. 2, consistency and predictability in our financing programs; No. 3, deep and liquid markets; and No. 4, a balanced maturity structure.

The financing tools that Treasury has had at its disposal in the past to achieve the goals and promote the principles I just described have included primarily the ability to determine the issue sizes, offering schedules, and types of securities offered.

Using these tools, Treasury has paid down debt by refunding our regularly maturing debt with smaller amounts of new debt. Repurchase of outstanding debt prior to maturity would represent another tool that would provide us with greater flexibility in meeting our debt management goals and would be consistent with the principles we have followed in meeting those goals. While we have made no decisions as to whether we will, in fact, conduct debt buybacks, publication of the proposed rule for public comment is the first step to making debt buybacks an actual debt management tool for the Treasury.

These buybacks would have a number of potential benefits. First, buybacks can enhance market liquidity by allowing us to maintain regular issuance of new benchmark securities across the maturity spectrum. This enhanced liquidity should reduce the Government's interest expense and promote efficient capital markets. Second, by paying off debt that has substantial remaining maturity, we would be able to prevent what could otherwise be a potentially costly and unjustified increase in the average maturity of our debt. Third, buybacks could be used as a cash management tool absorbing excess cash in periods such as late April when tax revenues greatly exceed immediate spending needs.

Among the issues which must be given careful consideration in the coming months is the budgetary treatment of proposed buybacks. As most older Treasury securities were issued in higher interest rate environments, repurchasing such debt in the near term would most likely require payment of a premium. Current budget practice would require that any premium paid by the Treasury to buy back debt would be treated as interest expense at the time of the buyback while future savings would be accounted for in future fiscal years. The future savings, in reality, would offset the up front expense paid in the form of the premium. In other words, the up front budget impact would merely reflect a difference in the timing of immediate outlays and future savings.

Although we cannot ignore this issue, we must do our utmost to ensure that budgetary treatment issues do not affect the efficient management of our Nation's debt. It is important to maintain both the integrity of our budget practices and our debt management. We must ensure that everyone understands that both our budget treatment and debt management principles will be upheld and their integrity maintained.

Having a mechanism in place through which Treasury can conduct debt buybacks is simply good policy. Debt buybacks can help fulfill our core debt management goals by improving our cash management capabilities, offering potential taxpayer savings, and promoting efficiency in capital markets through enhanced liquidity.

Mr. Chairman, as you stated in your announcement of these hearings, our goal should be to reduce significantly the national debt at the least cost to the taxpayer. This proposal is an effort to ensure that this Treasury Department and future Treasury Departments have another important tool in place with which to achieve that objective.

We look forward to continuing to work with this Committee and others to continue to advance these goals.

That concludes my opening remarks. I would be happy to take any questions.

[The prepared statement follows:]

Statement of Hon. Lee Sachs, Assistant Secretary for Financial Markets, U.S. Department of the Treasury

Mr. Chairman, Ranking Member Rangel, and distinguished members of the committee, it is an honor to be here today to discuss Treasury debt management and our proposal to create a mechanism to repurchase outstanding Treasury securities prior to maturity.

Mr. Chairman, I want to thank you personally and other members for the leadership this committee has shown on debt management issues. Your role in this area has been extremely helpful to the Department in exercising its debt management responsibilities in a fiscally prudent and non-partisan manner.

The fiscal discipline of recent years has helped to foster a strong U.S. economy and has led to our first back-to-back budget surpluses since 1956 and 1957. We expect this quarter to pay down $16 billion in privately-held marketable debt, bringing the total reduction to an estimated $100 billion by the end of FY 1999.

In 1993, federal debt held by the public was projected to rise to $5.4 trillion by 1999 if additional fiscal discipline was not imposed. In fact, the stock of publicly-held debt outstanding now stands at $3.6 trillion, more than $1.7 trillion lower than it otherwise would have been. As a result, Treasury debt is taking up an ever smaller share of the capital markets. In 1992, Treasury marketable securities represented 32 percent, or just under a third, of the U.S. debt markets. They now represent only 23 percent of the U.S. debt markets. Moreover, Treasury's share of the gross new issuance of long-term debt has been reduced by more than half. While we still have to issue debt to refund maturing securities, last year that Treasury debt issuance represented only 18 percent of new long-term debt issued in the United States, down from 40 percent in 1990.

Reducing the supply of Treasury debt held by the public has enormous benefits for our economy.

- It means that less of the savings of Americans will flow into government bonds and more will flow into investment in American businesses.
- It means less reliance on borrowings from abroad to finance American investment.
- It means less pressure on interest rates and thus lower relative borrowing costs for businesses and American families.

While reducing the debt held by the public greatly benefits the economy, it brings with it significant challenges. As a result of the reductions in publicly-held debt, the ongoing task of debt management for the Federal government will be very different in the years ahead than it has been in the past when debt was rapidly increasing.

Debt Management Goals and Principles

Before discussing our debt buy-back proposal in detail, I'd like to briefly review the goals and principles of Treasury's debt management program, which provide the background and context for the debt buy-back proposal. These goals and principles were outlined in greater detail for this panel last year when my predecessor, now Under Secretary Gensler spoke to you about debt management more broadly.

Treasury debt management has three main goals: (1) to provide sound cash management in order to ensure that adequate cash balances are available at all times; (2) to achieve the lowest cost financing for the taxpayers, and (3) to promote efficient capital markets.

In achieving these goals, we are guided by five interrelated principles:

First, maintenance of the "risk-free" status of Treasury securities to assure ready-market access and lowest cost financing.

Second, consistency and predictability in our financing program. Keeping to a regular schedule of issuance with set auction procedures reduces uncertainty in the market and helps minimize our overall cost of borrowing.

Third, maintenance of market liquidity, both to promote efficient capital markets and lower Treasury borrowing costs.

Fourth, financing across the yield curve. A balanced maturity structure enables us to appeal to the broadest range of investors and mitigates refunding risks. Providing a pricing mechanism for interest rates across the yield curve also further promotes efficient capital markets.

Fifth, unitary financing. We aggregate the financing needs for all programs of the Federal Government and borrow as one nation. This ensures that all programs of the Federal government benefit from Treasury's low borrowing rate.

The financing tools that Treasury has had at its disposal in the past to achieve the goals and promote the principles described have included primarily the ability to determine the issue sizes, offering schedules and types of securities offered. Using these tools, Treasury has paid down debt by refunding our regularly maturing debt with smaller amounts of new debt. To do this, we have reduced the size of our regular Treasury bill auctions, reduced the frequency of issuance of 5-year notes, and discontinued issuance of 3-year notes. At our last quarterly refunding announcement, we announced a reduction in the frequency of issuance of our thirty-year bonds. Aside from allowing us to maintain the size of our benchmark issues, this reduction also will help to keep the average maturity of our debt from lengthening further.

PROPOSED DEBT BUY-BACK RULES

Repurchase of outstanding debt prior to maturity would represent another tool that could provide us with greater flexibility in meeting our debt management goals and would be consistent with the principles we have followed in meeting those goals. While we have made no decisions as to whether we will, in fact, conduct debt buy-backs, publication of the proposed rule for public comment is the first step to making debt buy-backs an actual debt management tool for Treasury. We hope to have final regulations in place during the first quarter of 2000.

The process proposed for the debt buy-back program is fairly straightforward. Treasury would issue a press release, which would include the eligible securities and the total amount of the buy-back. Treasury would have the right to buy back less than the amount announced. Offers would be submitted through primary dealers. This limitation will enable us to make use of the Federal Reserve Bank of New York's open market facility. Other holders of eligible securities could participate through offers submitted to a primary dealer. The proposed rules call for a "reverse auction"—a multiple price process in which successful offerors receive the price at which they offered securities. Following the completion of the auction, Treasury would issue a press release providing for each security the amounts offered and accepted, the highest price accepted, and the remaining privately-held amounts outstanding. FRB New York will transmit results messages to primary dealers informing them of the acceptance of the offers they submitted.

BENEFITS OF BUYBACKS

We believe that buybacks would have a number of potential benefits as a debt management tool:

- First, buy-backs could enhance market liquidity by allowing us to maintain regular issuance of new "benchmark" securities across the maturity spectrum, in greater volume than would otherwise be possible. This enhanced liquidity should reduce the government's interest expense and promote more efficient capital markets.
- Second, by paying off debt that has substantial remaining maturity, we would be able to prevent what could otherwise be a potentially costly and unjustified increase in the average maturity of our debt: from just over five years to more than seven years on the current trajectory.
- Third, buy-backs could be used as a cash management tool, absorbing excess cash in periods such as late April when tax revenues greatly exceed immediate spending needs.

In addition, although it is not a primary reason for conducting buy-backs, we may occasionally be able to reduce the government's interest expense by purchasing older, "off-the-run" debt and replacing it with lower-yield "on-the-run" debt. A Treasury security is referred to as being "on-the-run" when it is the newest security issue of its maturity. An on-the-run security normally is the most liquid issue for that maturity and therefore generally trades at lower yields than off-the-run debt. Because an off-the-run security generally does not have the same liquidity as an on-the-run issue, it may trade at higher yields, and thus lower prices, than on-the-run securities. Treasury may be able to capture part of the yield differential and thus reduce the government's interest costs by purchasing and retiring older debt and replacing it with lower yielding on-the-run debt.

Before I came to the Treasury Department, I spent thirteen years at a major investment bank. I frequently advised major corporations on their debt management policies. Debt buybacks and exchanges are common debt management tools used by some of the most sophisticated corporations in the private sector. Similarly, other countries experiencing budget surpluses have explored and/or implemented buyback

programs to attempt to maximize the budgetary benefits of such surpluses. Even in the United States, the repurchase of outstanding securities that have not matured is not without precedent. Treasury conducted several debt exchanges or advance refundings between 1960 and 1966, and again in 1972 under which new issues were exchanged for outstanding, unmatured debt. In addition, the Treasury's Borrowing Advisory Committee has unanimously recommended the use of debt buy-backs as a debt management tool in the future.

BUDGETARY IMPACT

Let me now turn to the budgetary treatment of proposed buybacks. As most older Treasury securities were issued in a higher interest rate environment, repurchasing such debt in the near term would most likely require payment of a premium, which means that we would have to pay more than the face value of the bonds. Current budget treatment would require that any premium paid by the Treasury to buy back debt would be treated as interest expense at the time of the buyback. It would account for a future savings in interest expense in future fiscal years. The future savings, in reality, would offset the up-front expense paid in the form of the premium. In other words, the up-front budget impact would merely reflect a difference in the timing of immediate outlays and future savings. We also must recognize that not all securities trade at a premium. There are also securities, albeit a minority in today's environment, that trade at a discount to their face value. If buybacks were to involve such securities, the discount would lower interest outlays in the period during which the buyback occurred. Again, this would reflect a difference in the timing of cash flows.

Although we cannot ignore this issue, we must do our utmost to ensure that budgetary treatment issues do not affect the efficient management of our nation's debt. It is important to maintain both the integrity of our budget practices and the integrity of our debt management. We must ensure that everyone understands that both our budget treatment and debt management principles will be upheld, and their integrity maintained. Efficient debt management is consistent with the best long-run budget outcomes.

Having a mechanism in place through which Treasury can conduct debt buybacks is simply good policy. Debt buybacks can help fulfill our core debt management goals—by improving our cash management capabilities, offering potential taxpayer savings, and promoting efficiency in capital markets through enhanced liquidity.

Mr. Chairman, as you stated in your announcement of these hearings, "our goal should be to reduce significantly the national debt at the least cost to the taxpayer." This proposal is an effort to ensure that this Treasury Department and future Treasury Departments have another important tool in place with which to achieve that goal. We look forward to continuing to work with this committee and others to continue to advance these goals. I will be happy to answer any questions you may have.

Thank you.

—

Chairman ARCHER. Thank you, Secretary Sachs.

It might be helpful to the Members of the Committee if you could explain to us specifically what happens with the surplus in the event that there are no maturing bonds that will absorb those extra dollars. And I am talking now on a week-to-week, month-to-month basis. What happens, in practice, to the dollars that are received by the Treasury in excess of the bonds that are maturing and in excess of the bills you have to pay? What happens to that extra cash money when you have no maturing bonds to pay off?

Mr. SACHS. Mr. Chairman, we do have bonds that mature every week just by the nature of our maturity schedule. We issue new Treasury bills weekly and therefore they mature weekly so we will always have that. When dollars—when receipts come in, some of the money does go to pay those maturities. The excess cash that doesn't go to do that or is not spent can go into one of two places. Some of it will go into Treasury's account at the Federal Reserve,

and the balance of it will go into the TT&L accounts which are essentially accounts at various commercial banks throughout the country.

Chairman ARCHER. Are there any limitations as to how much of that excess cash can be put in either one of those depositories?

Mr. SACHS. Practically yes. The capacity of TT&L accounts tends to be—although it is not an absolute ceiling—around $60 billion. There is not necessarily a cap on what we could put with the Federal Reserve, but the more we put there, the more it affects their open market operations.

Chairman ARCHER. And what interest does the Treasury receive on the funds that are put with the Federal Reserve?

Mr. SACHS. I am sorry?

Chairman ARCHER. What interest rate does the Treasury receive on the funds that are placed with the Federal Reserve?

Mr. SACHS. I believe it is the overnight repo rate; it is a market-determined interest rate.

Chairman ARCHER. What interest does the Treasury receive from the depository banks?

Mr. SACHS. It is the Federal funds rate less 25 basis points.

Chairman ARCHER. And how are those banks chosen?

Mr. SACHS. I believe there is a list of banks that has been in place for some time. It includes the top-tier quality banks in this system. That is a list that has been around for quite some time. I don't think we have changed that in a while.

Chairman ARCHER. How is that list determined?

Mr. SACHS. Mr. Chairman, I am not sure of the history of how that list got put together. I know that on the list are some of the largest, most credit worthy banks in the system.

Chairman ARCHER. Within that list, how is the decision made as to which of the banks get what amount of money?

Mr. SACHS. We try and spread it as evenly as we can.

Chairman ARCHER. The amounts would clearly be in excess of the FDIC guarantees, insurance guarantees. Is that a wise thing to do to have the taxpayers' money in large chunks in bank deposits, private banks across the country?

Mr. SACHS. These deposits are collateralized.

Chairman ARCHER. In what way are they collateralized?

Mr. SACHS. The banks in which we would deposit these funds put up securities as collateral to support the credit worthiness of those deposits.

Chairman ARCHER. I appreciate your taking us through that just so we have a basic understanding.

Clearly, it would be better if we could find a way that that money can be used to pay down the debt rather than to simply sit in a bank account; and I think that is probably one of the aspects of your suggestion relative to buying debt that has not yet matured.

Do you need a change in law to be able to do that?

Mr. SACHS. To buy back debt?

Chairman ARCHER. Buy debt that has not matured?

Mr. SACHS. No, sir. The Treasury currently has authority to enter into debt buybacks.

Chairman ARCHER. And when do you propose to initiate this process after you have had public response to your suggestions?

Mr. SACHS. Mr. Chairman, as you know, we are coming up toward the end of the comment period. We released the proposed rule at the beginning of August. The 60-day comment period ends next week on October 4. We will take the next several months to go through any comments that come in, formulate the final rule, and we hope to have it in place sometime in January.

As to when we might enter into actual debt buybacks, we haven't made any decisions on that yet. I would expect it would be—might be earliest, in the first quarter of next year.

Chairman ARCHER. Do you have a time period in advance that you would want to issue public notice of your intention to do that prior to the starting date?

Mr. SACHS. We have been talking about that. We don't have a specific time period in mind yet. It is something on which we have invited public comment. We will be interested to see what the public has to say about that.

Chairman ARCHER. Do you have a projection of how much added interest charges would occur in the first year after you began this operation? You commented that the premium that you would have to pay, and you would have to pay a premium for the higher interest bonds which would be the ones you would want to retire, would that premium be charged as an interest expense in the year of the purchase?

Mr. SACHS. Correct.

Chairman ARCHER. How much extra interest expense would occur in the first year?

Mr. SACHS. Again, Mr. Chairman, it is hard——

Chairman ARCHER. I know it would depend on how much you bought, and et cetera, but what are your projections as to what the increased interest expense might be in the first year?

Mr. SACHS. Honestly, we don't have projections at this time. The amounts that we might purchase will, in part, depend on what the surplus looks like at that time and what the markets look like at that time. It would be very difficult to—unfortunately, it is very difficult to answer that question this far in advance.

Chairman ARCHER. For how many years would there be added interest expense before you began to witness savings that would offset the interest expense?

Mr. SACHS. The savings would begin to occur really as soon as you——

Chairman ARCHER. I understand, but certainly in the first year the added interest expense would exceed whatever savings you would have.

How long would it take before the aggregate savings would equal the added expense?

Mr. SACHS. That would depend on what bonds we purchased and how big the premiums would be. If we were to buy some shorter term bonds with lower coupons, the premium would be lower, but it would also take longer for the savings to accrue.

Chairman ARCHER. Have you attempted to run this through your computer model to get some sort of feeling about what might be an average projection?

Mr. SACHS. No, sir. I can tell you this. We have looked at what the average dollar prices are of our bonds, but without knowing how much we would purchase or specifically which ones we would purchase, it is really hard to answer this question.

Chairman ARCHER. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I gather from your response to the chairman that you don't need any congressional authority to do the things that you are suggesting you want to do.

Mr. SACHS. That is correct.

Mr. RANGEL. And you are like an investment banker for the Federal Government that you look at the interest rates that we are paying and purchase back before maturity certain bonds with the idea that you are going to get a better deal in buying debt. Therefore, the ultimate goal is to reduce the debt, and ultimately we will be reducing interest payments overall that our government has; is that correct?

Mr. SACHS. Yes, sir.

Mr. RANGEL. Right now, you just don't know the mix because you don't know the market and just what bonds you will be buying and where will you be reinvesting?

Mr. SACHS. Correct.

Mr. RANGEL. But what the chairman was trying to say is that we, of course, who look for short-term answers would want to know that as a result of you doing the best that you can for our government and the marketplace, just how well are we doing? Just how much debt actually is being reduced? Just how much interest is it that we don't have to pay? Just how much surplus will be increased as a result of the good work which you are trained in doing that you will be doing for the Federal Government?

Now, we recognize you can't speculate and give us a figure now, but to reframe the chairman's question, is there a period of time that you can review what you have done and determine what you have saved?

Mr. SACHS. Yes. We should be able to do that. The savings that we would generate are derived in a number of different ways. Clearly, by repaying higher coupon debt and refinancing with lower coupon debt, there are savings there. The savings that will be harder to identify, but which will be equally meaningful, are the savings that we would generate by creating additional liquidity in the Treasury securities market.

It will be hard to look back and say that by virtue of having done this, we have increased liquidity by a certain amount and that that will have reduced our interest rates by –X number of basis points. It is not that easily measurable, but we do know that by increasing liquidity, investors will demand a lower interest rate for the securities they buy from us than they would if we had less liquidity.

Mr. RANGEL. The banks that the chairman was referring to that you use for these Treasury bonds, do they compete in terms of trying to solicit their selection? And the follow-up question would be, are minority banks involved just because they are minority banks in terms of being partners in these transactions?

Mr. SACHS. It is the same interest rate for all banks, so it is not a competition on price. They take our deposits and pay us the Federal funds rate minus 25 basis points, or less a quarter of 1 percent.

As to your follow-up question, if I could ask to get back to you with an answer on that. I am not that familiar, as I said, with the list of institutions.

Mr. RANGEL. Last, this seems like it has got to be generating a lot of transactions and including a lot of brokers. Do we expect that commissions, brokers' commissions, and transactions costs for buying back debt and purchasing new shorter interest, lower interest, debt is going to increase the cost of these transactions?

Mr. SACHS. I would not expect so. We do not pay those costs. The way we have outlined how the program would work is that the offers to the Treasury Department are competitive. In other words, we get to choose the most attractive offers that are out there, the cheapest securities for us. So I do not believe that that would be a factor.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman. I have just one question and that is, are your projections anticipating a fall in long-term interest rates?

Mr. SACHS. Our projection—which projections are——

Mr. CRANE. If you are buying long-term debt with short-term debt, isn't that predicated on the assumption that long-term debt interest is going to fall?

Mr. SACHS. This proposal is not specifically saying we would buy long-term debt and issue short-term debt in its place. What this proposal would allow us to do is to streamline our inventory of debt, in other words, to buy some of the higher coupon, less liquid securities that are out in the market and essentially consolidate those into larger, more liquid issues that may have a longer or a shorter maturity than the securities we purchased. It is not necessarily buying long-term debt and replacing it with short-term debt.

Mr. CRANE. I yield back the balance of my time, Mr. Chairman.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

During this period of buying back higher-interest-paying bonds at a premium, are we still issuing new bonds during this period?

Mr. SACHS. In some cases, yes; in some cases, we're not. To the extent that we are reducing debt outstanding, we will not necessarily be issuing as much new debt in its place.

Mr. SHAW. If we were to just simply put a moratorium on issuing new debt, would this be sufficient to take care of the surplus?

Mr. SACHS. What would happen in that case is, we would have greatly reduced liquidity in the Treasury market. We still do have to roll over our maturing debt, and the reduced liquidity would increase the cost of refinancing the debt that was maturing. The lower the liquidity in the market, the higher the interest rates we would have to pay on the new bonds we would issue.

Mr. SHAW. I am missing something. It seems to me that if you reduce the number of bonds that we issue, that you would get a

better price for them because the supply would be down and, therefore, the interest rate would drop on what we have to pay on the debt that we are refinancing if we cut down on the supply of new bonds being issued. Am I correct on that?

Mr. SACHS. Yes, sir.

Mr. SHAW. Is that inconsistent with what you just said?

Mr. SACHS. No, it is not inconsistent. There is the total amount of debt outstanding to which you are referring, and we are reducing that. The composition of what remains outstanding is what I am referring to. If the total amount of debt we have in the market were concentrated in larger, more liquid issues, that should lead to lower interest rates because there would be greater liquidity in those bonds. If the total amount were spread over many more issues, they would be less liquid, and that would most likely result in higher interest costs.

Mr. SHAW. When you are buying back some of the higher-interest-paying loans, what type of term are you looking at on these bonds?

Mr. SACHS. Those decisions would be made at the time of the buyback operations.

Mr. SHAW. Have you done some analysis to try to figure out what is best for us in the long run? Is it best we buy long-term bonds that are high interest rate or is it best that we buy 1-year bonds?

Mr. SACHS. Again, it will depend on what the market looks like at the time of the buybacks.

Mr. SHAW. Do you just go into the market and buy these bonds as anyone would, as a bank would? How do we pick and choose which bonds are being purchased?

Mr. SACHS. We are trying to set up a mechanism, and again we are in the comment period of soliciting input from the private sector in terms of exactly how we would execute these buybacks, but the way it is currently contemplated is that we would announce our intentions with some advance notice. We haven't determined how far in advance—how many bonds, maximum, we would like to buy, and approximately where in our maturity spectrum we would like to purchase them.

I don't know if that answers your question, but that is the mechanism we would use and offers offerers—would offer competitively those securities.

Mr. SHAW. Do we have any experience to draw on? Have we ever done this before?

Mr. SACHS. It is not exactly the same thing, but back in the 1960s and early 1970s, the United States engaged in what is called an exchange offer where new securities were simultaneously issued in exchange for securities that investors could turn in.

Mr. SHAW. I have one more question. What do you contemplate will be the impact on our budget of this added interest expense? Is it going to be negligible, or is going to be something we in the Congress are going to have to deal with?

Mr. SACHS. Again, it is hard to say how much the interest—the up front interest expense would be in engaging in these operations because we don't know how much of it we would do. Again, the interest premiums that would be paid would result in a reduction in

the current year's surplus. It does not have an effect for the following year's——

Mr. SHAW. That is what I am concerned with because all of us are working with that surplus and trying to figure out how we are going to stay within caps that we have set for ourselves. My question simply is, is this something that we have to be concerned about? Are these premiums going to break the caps, are they that significant? What kind of dollars—are we talking about—millions or billions or multiple billions?

Mr. SACHS. Again, I wish I had an answer for you today on the size.

Mr. SHAW. If you could make some projections, I think the leadership in the House would really like to take a look at it. Not that we need another problem, but I think it is something we should anticipate.

Mr. SACHS. I should also just reiterate, if I could make two points. I see the light is on. The premiums that we would pay by buying back these securities would not have an effect on the cap issue. Treasury currently has the authority to engage in this. It does not require a change in law; it does not require offsets. So I don't think——

Mr. SHAW. But we have to consider where those monies are going to be coming from. And I see my time has expired.

Chairman ARCHER. A little while back.

Mr. SHAW. Yes, sir.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Sachs, welcome. I am going to be getting back to the point Mr. Shaw made. As I understand it, when you make a decision to repurchase, that will have no impact on the total amount of debt that is outstanding, but just the mix of your inventory as to the length of maturities and what inventory of publicly-held debt you think is in our best interest from liquidity, from cost, and from market conditions.

Is that a fair assessment of why you want this tool?

Mr. SACHS. That is one reason, sure. This tool would, as I tried to indicate earlier, this tool would allow us to hopefully reduce expense over time.

Mr. CARDIN. But the repurchase itself will not reduce the amount of publicly-held debt because it will be less new debt that you are going to be incurring, or be more new debt that you will be incurring, but different maturities, to get the type of liquidity and the type of cost and the type of impact on the market that you think is in the best interest of our Nation.

Mr. SACHS. That is correct. In and of itself, this purchase does not reduce the debt.

Mr. CARDIN. Let me get to Mr. Shaw's point, because I think it is a very important point.

I understand you can't predict what the cost will be. You don't know if you will use this tool in the first quarter of next year; and if you use it, you don't know to what extent, you don't know what the market conditions will be, you don't know what you will be repurchasing and what you are going to be issuing. It is impossible to tell the impact now.

But the point Mr. Shaw raises is a very valid point. If you use this in the first calendar quarter of 2000, it will affect the amount of surplus in fiscal year 2000. It may not have a major impact, but it will have some impact because we will be spending more on interest in 2000, admittedly saving interest costs over a period of time—just the opposite of what Congress normally does. We usually try to figure out some way to spend money now, but not count it now.

Now, what you are doing is saving us money, but we have to pay for it now. Just one of these reverse things that Congress is not used to, this type of fiscal responsibility.

But I think it is important for us to try to calculate whether this is going to have a negligible impact or a significant impact as we look at projected surpluses and how we in Congress wish to manage the projected surpluses of the future.

Mr. SACHS. Congressman, thank you. I know a lot of you have asked this question. No one wishes I had an answer today more than I do.

If I could use a private sector analogy for a moment, before coming to Treasury I spent 13 years in the private sector in an investment bank where one of my primary responsibilities was advising corporations on how to manage their debt structures and what they should do in this area, and many of the largest, most sophisticated corporations are using this tool right now and have been for some time.

The way this is treated when they do it—and they are focused on their earnings every quarter and every year—is that when they purchase some of their debt in the market at a premium, that premium, it is not scored, but it is accrued in the year in which they buy that debt back. It is reflected in their earnings for that quarter. And the way they show that is, they obviously have to show the number. Their earnings will be reduced by that premium in that quarter.

They also show the number as it would have appeared had they not entered into that operation. And that is the number that the analysts look at. The analysts—all the analysts and investors view this as a very positive thing for them to do. They understand they are reducing their interest costs going forward.

Mr. CARDIN. Mr. Sachs, let me interrupt you for a moment because I agree with you. I am for you having this ability to use this tool.

You are absolutely right; our accounting system should accurately reflect the current cost, and you should be able to accrue and therefore not be penalized for saving us money. And Mr. Nussle and I have worked on some budget reform proposals here to try to move us toward more accrual accounting in the budget system.

I would be somewhat concerned, though, that if we only do this type of an accrual to make the budget look rosier, we should be doing some of the accruals that are doing the reverse—that is, that we are incurring obligations today, but we don't pay for them until tomorrow—but it seems like Congress never wants to take responsibility for what we really spend today.

You are doing—I am complimenting Treasury because you are doing just the reverse. You are willing to pay somebody today to

save us some money in the future. We normally do it just the reverse. These are some things we should have been doing for a long time and our accounting system should reflect that.

Mr. SACHS. Thank you, Congressman.

Chairman ARCHER. The gentleman from Maryland has put his finger on something that should be a priority for all of us in the Congress and that is to make sense out of the way the Federal budget is determined. You highlighted only one part of it: that is not the way the private sector would do it, but there are many, many other parts that need to be changed also.

Let me just piggyback for a moment on what you said, Mr. Cardin, by asking one question first. When we talk about our debt, do we talk about net debt or gross debt? The gross debt would be what we owe in bonds, but then that should be offset to the degree that we have money owed to us by banks and by the Federal Reserve. That money is sitting in a bank depository, and it is owed to the United States of America, so do we reflect net debt or gross debt?

Mr. SACHS. It depends. Again, it depends which number you are looking at.

Chairman ARCHER. That is what I am asking you. What numbers do we look at when we talk about debt?

Mr. SACHS. For the purposes of this discussion, the debt we are focused on is the privately-held, marketable debt held by the public.

Chairman ARCHER. Again, from an accurate bookkeeping standpoint, that should be reduced by the amount of debt that is owed to us on these cash balances; should it not? There would be no private corporation that would exclude the money that was owed to them from the amount of their net debt? That is OK. It is just another anomaly in our budgeting concept.

The point I would make relative to what Mr. Cardin said is that obviously the amount of surplus that we have reduces the amount of debt.

Mr. SACHS. Yes.

Chairman ARCHER. If we reduce the surplus, we are going to have more debt.

Mr. SACHS. Yes.

Chairman ARCHER. OK. If your immediate funding mechanism reduces the surplus by having a higher interest charge in the first year, then we are going to have more debt in that first year. That has to follow.

Mr. SACHS. Yes.

Chairman ARCHER. That is net in the first year. So it actually does —although it may be a relatively small amount of money—increase the debt in the first year.

Mr. SACHS. That is correct.

Chairman ARCHER. Thank you for letting me piggyback on your comments, Mr. Cardin.

Mr. Houghton? Is Mr. Houghton here?

Is Mr. Foley here?

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. I simply want to compliment Secretary Sachs for his testimony. I have no direct ques-

tions, but we are looking forward to seeing your plan go forward. Thank you.

Mr. SACHS. Thank you, Congressman.

Chairman ARCHER. Is Mr. Lewis here?

Mr. McNulty is not here.

Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman.

I find this—I guess it speaks to my idea of Federal Government, but I find this entire exercise fascinating, and I am glad you are here and I am glad we are talking about how we manage the Nation's debt and how we reduce it by buybacks or otherwise.

I want to call your attention to this GAO pamphlet that was published in May, and on page 28 of that, the following appears: CBO figures show that if all projected surpluses are retained and are used to reduce debt held by the public, net interest primarily, the interest paid on debt held by the public, will decline from about 15 percent of the net outlays in fiscal year 1998 to about 4 percent in 2009. CBO numbers also show that about 23 percent of the growing budget surpluses over the next 10 years come from interest savings if the surplus is maintained and is fully used to reduce debt held by the public.

Using CBO estimates, if the budget were to be in balance rather than in surplus from 2000 to 2009, net interest costs in fiscal year 2009 would be $123 billion greater, or about $568 billion cumulatively between now and then. Now, that, to me, is the reverse of the power of compound interest as some people like to come here and talk about so much, and—first of all, let me—do you agree with the GAO analysis that I have just described here generally, or would you want to comment on that?

Mr. SACHS. It sounds right. This was just put in front of me, but it sounds correct, yes.

Mr. TANNER. Would you agree that the efficacy of paying this surplus on the debt, as opposed to virtually any other use of this "extra money" in my view, given these kinds of observations, far outweighs almost any other single use we could make of this "extra money."

Mr. SACHS. There are certainly tremendous benefits to the economy in reducing the debt that you are referring to.

Mr. TANNER. If it seems this is true, we have as a percentage of GDP now a historically high debt vis-a-vis peace versus war. Over 40 percent of the GDP is held by the public and then another 20 or so is, so-called, held by the Government.

Mr. SACHS. Yes.

Mr. TANNER. So over 60 percent of our GDP we have outstanding—well, said another way—you characterize it for me, please.

Mr. SACHS. The debt held by—I don't have in front of me what you have in front of you, but the debt held in government accounts is obviously very different than debt held by the public.

Mr. TANNER. 1.8 versus 3.6 thereabout.

Mr. SACHS. Interest on that debt is interest we are paying to ourselves as opposed to paying to third parties.

Mr. TANNER. On page 3 at the top of the page of your testimony, you have informed us of some of the tools that you have used.

When debt matures, you issue a smaller amount of debt. You have ceased issuing 3-year notes here, it says.

Mr. SACHS. Correct.

Mr. TANNER. Using these tools, you have been able to achieve what in terms of debt reduction?

Mr. SACHS. Over the course of the last 2 years, during which we have had the back-to-back budget surpluses, we have been able to reduce the amount of the privately-held marketable debt, which is what this proposal is dealing with, or would be dealing with, by roughly $210 billion, which is, by the way, a reduction of almost 7 percent of the outstanding privately-held marketable debt.

Mr. TANNER. On an average interest rate of 5 percent, $200 billion would be an interest savings of $10 billion a year, roughly. Would that be—.

Mr. SACHS. When I was in the private sector, I was faster at doing math in my head.

Mr. TANNER. Five percent of $200 billion, if that is what you owed and what you paid, and it was for—our average rate, I think, is 6, around 6; is that correct?

Mr. SACHS. I don't know what the average interest rate was on the debt that matured over the last 2 years.

Mr. TANNER. But if it were 5, you have got a $10 billion savings every year forever.

Mr. SACHS. That would be a good thing.

Chairman ARCHER. The gentleman's time has expired.

Mrs. Johnson.

Mrs. JOHNSON of Connecticut. Thank you, Mr. Chairman.

Thank you for being with us today on what is a very important subject. I wanted to just take you back in history and have the Treasury give us some historical data. In 1993, the administration changed its debt management policies by issuing more short-term and less long-term debt.

What was the actual savings by that policy in the ensuing years?

Mr. SACHS. Congresswoman, if I could get back to you on that answer——

[The following was subsequently received:]

In May 1993, the Treasury announced that it would be instituting a shift in the maturity of its borrowing toward shorter term issues. The actions taken were to pare back the issuance of 30-year bonds, from four to two times per year, and to discontinue issuing 7-year notes. The funding would be shifted to a mixture of securities with maturities of three years or less.

In May 1993, OMB estimated the savings of reducing the average maturity in the FY 94–98 period to be $10.8 billion, while CBO's estimate of savings for the same period was $7.3 billion. Although OMB did not update its estimate, in May 1994, CBO reported that it had no reason to change its original forecast. Subsequently, it was generally recognized that, given the cumulative effects of deviations of the actual deficits and interest rates from the original baseline forecast, calculations of the actual savings resulting from any one particular change would be unreliable. It is, however, generally recognized that the savings to the government of the May 1993 decision were significant and may have exceeded original estimates.

—

Mrs. JOHNSON of Connecticut. I would appreciate your getting back to me, and I will tell you why I want you to get back to us, year by year. The projected savings from that policy change were

substantial, and I think it is very important, as we look at the management changes you wish to make now, to know what the savings were from issuing more short-term debt and less long-term debt in 1993.

I also wanted to—that, I think, will help us to evaluate what our options are at this type.

Then a number of countries like Britain and Canada have begun reducing debt and they have run into some pretty serious problems. In Great Britain there is a shortage of long-term government bonds for pension funds to invest in. That is a very serious problem. Are we anticipating those kinds of problems? Are you factoring the experience of other countries into your planning?

Mr. SACHS. Congresswoman, we are certainly looking at the experience of other countries as we go through this. I should reiterate that the proposal that we are discussing today is an effort to enhance the liquidity of our long-term securities. This proposal would not necessarily accelerate the pace at which we would reduce the amount of outstanding securities.

Mrs. JOHNSON of Connecticut. I think we need to be able to see what you are proposing at this time in the context of what you began actually doing in 1993 and see what the impact was there, whether it reduced the cost of our debt to us or actually increased those costs, how the real costs compared to the estimated either savings or costs—at that time they were estimated as savings—and how your current proposals relate to your earlier actions in 1993.

Mrs. JOHNSON of Connecticut. In addition, I would like to just get a brief answer because I would like to make a comment after that. What is going to be—what impact will your new policies have on the time at which we hit the debt ceiling limit of $5.995 billion?

Mr. SACHS. This buyback proposal?

Mrs. JOHNSON of Connecticut. Yes. Will it defer the day at which we come up against the debt ceiling?

Mr. SACHS. It should not have a meaningful impact on that.

Mrs. JOHNSON of Connecticut. If we are in an era of debt surplus, it seems that we ought to be able to figure out how to move that date.

I would like you to look at Mr. Shaw and Chairman Archer's Social Security reform proposal. Rather than putting those surplus dollars into new debt, which is what we do when new Social Security dollars come in, we buy new debt with them and then we are obliged to that debt, and ultimately taxes will have to go up unless we have made other provisions to repay that debt, it actually spends those Social Security dollars, but in a way that does secure them in investment savings accounts so we don't buildup new debt and we do, as a fact, eliminate Social Security from that balance sheet. I think when you talk about debt management, you really ought to be thinking about the Archer-Shaw proposal as an extraordinarily powerful debt management tool.

Mr. SACHS. Congresswoman, I appreciate your comments.

The proposal that we have in front of us today is this buyback proposal. It does not have an impact on Social Security one way or another except by virtue of putting downward pressure on interest rates. That—and reducing our borrowing costs.

Mrs. JOHNSON of Connecticut. If it ends up costing us, then that money will come out of basically Social Security revenues as many costs have in the past. We hope to get through this budget year and not spend—our intent is not spend any Social Security revenues, and we are pretty committed to that. There is more than us at the bargaining table, however. I just urge you to look at that.

Mr. SACHS. Sure. We believe that this proposal will save the taxpayer money.

Mrs. JOHNSON of Connecticut. Thank you.

Mr. CRANE. Ms. Dunn.

Ms. DUNN. No questions.

Mr. CRANE. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Just following up on Mrs. Johnson's question, there has been a statement made by the administration, that a line has been drawn in the sand, which says that the President has pledged to save Social Security first before spending any amount of the surplus. My question to you would be does this debt buyback program increase short term costs?

Mr. SACHS. This debt buyback program, if we were to engage in transactions and buy securities in the open market that have dollar price premiums, would be reflected in a lower budget surplus number for the year in which the buyback occurred.

Mr. PORTMAN. And that would mean that there are short term costs in that buyback year; and, therefore, the surplus would be affected, and have you already saved Social Security?

Mr. SACHS. The savings——

Mr. PORTMAN. That is a rhetorical question.

Mr. SACHS. The savings that would be generated by virtue of engaging in this exercise would——

Mr. PORTMAN. Would there be long term savings?

Mr. SACHS. Yes, which would put us in a better position to be able to meet our future obligations, including Social Security.

Mr. PORTMAN. Without Social Security reform, how are the debt buybacks paid for?

Mr. SACHS. The debt buybacks, again because there is no—I hope this is answering your question—because there is no change in law required for us to engage in these buybacks, they do not require offsets as might otherwise be required.

Mr. PORTMAN. But it affects the surplus?

Mr. SACHS. It does affect the surplus, yes, in the current year.

Mr. PORTMAN. Which means in a case of no on budget surplus but Social Security surplus, which seems likely for next year, there would be a cost to the Social Security surplus without having first saved Social Security?

Mr. SACHS. It would not. When Social Security, when Social Security has surpluses, they invest in Treasury nonmarketable securities, as they would whether we engaged in debt buybacks or not.

Mr. PORTMAN. But for that year there would be less surplus to invest in those?

Mr. SACHS. There would be a lower surplus reflected at the end of that fiscal year.

Mr. PORTMAN. I guess the line in the sand like other lines in the sand in this political world, may not really be a line in the sand. Over time you think it would have an impact which would be posi-

tive for taxpayers, but in the meantime we would not be reforming Social Security while moving ahead with using some of that surplus for immediate buybacks which would have a cost to the surplus. Therefore, the pledge to save Social Security first before touching the surplus would be difficult to fulfill.

Mr. SACHS. But again, Congressman, the purpose behind this proposal is to reduce the cost to the Federal Government.

Mr. PORTMAN. Long term?

Mr. SACHS. Yes, absolutely. And again that puts us, the Government, in a better position to meet all of those long term obligations, including Social Security.

Mr. PORTMAN. Following on Mrs. Johnson's comments, I think it does cross the line in the sand and once again indicates the need for us to get serious about Social Security reform and investing that surplus as proposed in the Archer-Shaw bill, or in assets that have a higher return on investment where we actually have the money work for the Social Security recipients rather than investing in the treasuries. I thank you for your time today.

Mr. SACHS. Thank you, Congressman Portman.

Mr. CRANE. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman.

Let me say that this is an intriguing time in our discussions of budgets and what we do with surpluses. Some have said with debt buybacks we don't generate from this following interest rates, we are not accomplishing the situation, and I think also the gentlelady from Connecticut's point is valid. I am concerned whether you are going to buy back long term or short term debt. You didn't give a specific answer on that. I know in 1993 the administration moved to try to shorten everything to short term debt. To me you don't have to be a rocket scientist to realize if we are going to deal with it, you need to look at long term debt. What is our obligation on long term and what is our obligations on short term? Do we have those?

Mr. SACHS. I have those figures for you. Again it depends on your definition of long term. Longer than 1 year, we have notes and bonds with original maturities longer than 1 year of about $2.5 trillion, just doing the addition in my head.

And bills with maturities 1 year or less are about $650 billion.

Mr. WATKINS. I look at anything less than 5 years as short term.

Let me say if we are looking at it, we should be looking at long term. There is no question—I agree with the policy in 1993. I think we should look at the short term and I think Rubin and others had some good points on that. I think down the road we need to be saying how do we reduce the long term and I think we should look at the overall obligations. I want to add this tidbit, we need to be looking at what our trade imbalances are doing and those imbalances that are bringing in a lot of money from a lot of other countries. I think that would be very, very important.

I would go through some of the same questioning as some of the others, but because of time I won't.

I will make this point. When I served in the State Senate in Oklahoma, probably one of the most proud votes I cast was where we had one on buying down debt and paying off bonds, and I was

a lone no vote. I had to explain where I went. People didn't understand.

I went down to the treasurer's office in the vault and I read the bonds. We paid off bonds at 1 percent. If I cannot take the public's money and make more money than that, then I shouldn't be in public service.

I think we need to look at what we are doing. Archer-Shaw may allow us to put that money into savings that make twice as much than what we are paying off. We need to be making that—that is what a businessman would do. You came out of Wall Street and I came off Main Street as a small business man, but I wouldn't be a good steward of the people's money if I didn't get the kind of return from it that we should, and that is nearly Biblical in some respects. But I think just as I cast that vote years ago, I want to make sure that I cast one that will help secure that future for the future generations. If something does happen right now and we end up going to the buyback, I think we need to take some long term debt out of circulation instead of short term.

Mr. SACHS. Just to go back to the first point that you were making, as I indicated in my opening remarks, one of the reasons that we would like to have this tool in place is to efficiently manage the average maturity of our debt. People can have different opinions about whether our average maturity should be 5 years, 6 years, 7 years. But we don't want to have our average maturity extend beyond where we would otherwise want it to. Without our ability to buy back debt, it would extend as it did last year.

Mr. WATKINS. I submit to you if we actively manage our surpluses, we can control the maturity of those debts, but we have to actively manage them, not just dump everything in at one time.

Mr. CRANE. The time of the gentleman has expired. We want to thank you, Mr. Sachs, for your appearance here today. The Committee will stand in recess subject to call of the Chair for the two votes that we have on the floor right now.

[recess.]

Mr. NUSSLE [presiding]. At this time the Committee will resume its hearing, and we would request that Mr. Posner, who is the Director for Budget Issues, Accounting and Information Management Division of the U.S. General Accounting Office, take the witness stand. We appreciate you coming today and we would recognize you at this time for 5 minutes.

Without objection your testimony will be placed in the record and you can feel free to summarize it at this point. Thank you.

STATEMENT OF PAUL L. POSNER, DIRECTOR, BUDGET ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY TOM MCCOOL, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKET ISSUES, AND CAROLYN LITSINGER, HEAD OF WORK ON FEDERAL DEBT

Mr. POSNER. Thank you, Mr. Chairman. I want to recognize Tom McCool on my right, who is the director of GAO's financial institutions and market issue area, and Carolyn Litsinger on my left, who is head of work on Federal debt.

We provided two GAO reports for your packets, one we issued several months ago, a primer on the Federal debt. In our view we think that it helps to have some basic tools to understand this issue better. Interest costs in the budget are the third largest program in the Federal Government, and we think that understanding more the dimensions and the dynamics and the importance of debt can be helped by this kind of tool. We just issued today for yourselves and for Senator Domenici a study following on this primer on the management of Federal debt in a time of surplus and the new challenges, and that is what I am going to talk about today.

As you know, the debt held by the public has gone down thanks to 2 consecutive years of surpluses. The publicly-held debt now stands at $3.6 trillion. The CBO projections show if we continue to save all of the surpluses, on and off budget, debt held by the public would be falling to less than a trillion dollars in 2009 or about 6 percent of the economy, which would be quite a low figure for our history.

Basically the Assistant Secretary did a good job of stating Treasury's goals for debt management. Those goals remain valid in times of surplus or deficit. However, in surplus there are some unique challenges that come to the fore. In a surplus period, the profile of the maturities of your debt essentially is a large function of the kind of debt that is already maturing and due to mature.

The resulting profile can shift somewhat automatically, unless you take active intervention to change the mix. Just for your information, the chart shows that notes are the predominant form of Treasury security. Bills are 10 percent of the total, and this is as of July. Long term bonds are 20 percent, and a small portion are inflation adjusted.

The story of debt management in the 1998 and 1999 period illustrates the challenges in 1997 and 1998 we had what is known as an April surprise. We had a large amount of revenues that came in the door, larger than anyone projected, either OMB or CBO, and as a result the cash balances grew. In order to address that problem, Treasury reduced the issuance of new bills. In other words the short term bills were the ones that came due frequently, and because they were the ones that came due most frequently, they were the ones that took the hit on the surplus, if you will.

And as a result, we emerged with a disproportionately lower stock of bills at the end those 2 years. While total debt was reduced by 3 percent, the total stock of bills was reduced by 9 percent. The short term market began to experience liquidity problems because the supply of bills was shorter than the demand. Arguably Treasury borrowing costs were somewhat higher because the profile of debt had lengthened as a result.

If we just let debt go on automatic pilot, these would be a continuing lengthening of the profile of the debt and a possible liquidity problem in the bill market at that time.

To respond to that, Treasury did several things which illustrate how active management is important in this area to address these problems. First, they used more actively issued cash management bills early in 1999 that enabled them to reduce the size of the cash balances on hand.

The second thing they did is to concentrate borrowings in fewer issues. We know that they eliminated the 3-year note, for example.

The third thing they did, was to reduce the notes that they issued disproportionately which enabled them to increase the issuance of bills. What that meant is that since the notes had longer maturity, they were able to rebalance their profile to some extent. So as a result of those actions, in other words, even in months when the cash was in a deficit position, they did not reissue notes that were coming due to fund the Government's needs. Instead they issued bills in their place. And the aggregate effect of that was that for modified and mitigated the slide towards longer-term debt.

We know and Treasury has testified that we have a continuing problem here in the sense that as debt continues to come down, the choices will get harder. Again, it requires a more active strategy to achieve Treasury's various goals.

Treasury in August announced further measures to further concentrate on securities and, as we know from the hearing today, buybacks to actually reduce off-the-run issues and thereby gain the ability to prop up the more liquid benchmark issues.

Let me address three tools that we see available to Treasury. One is the buyback which I will talk about here in a minute.

We also know that Treasury traditionally uses reopenings where active issues are enriched to prop up the liquidity of benchmark issues.

Treasury can also buy back bonds without a premium that are callable. At this point there are no callable bonds. There will be one coming due—reaching its callable period in year 2000, and over the next 9 years there will be $87 billion of callable bonds. But as it stands, in order to buy back the outstanding higher cost debt, Treasury has to pay a premium. Based on what we have seen in some other countries and corporations, we know that buying back debt is a legitimate strategy to actively manage your debt portfolio and to try to promote liquidity. Canada, for instance, is in the process of doing this. The problem is that premiums must be paid to get investors to sell the bonds valued above par, which are most of the outstanding bonds. This is not a scoreable event in congressional budget terms. There is no pay-go hit. There are no offsetting savings that must be found. The issue is that it would be recorded as a reduction in the surplus and counted on a cash basis as a cash outlay. However, it also should be noted that over time, the baseline would be lower under current interest rates because your interest costs would be reduced. So it is really a timing shift, recognizing the higher cost debt that you have already accumulated in 1 year rather than spreading it out over time.

There are challenges here in terms of how we can consider this technique of debt management under our current process. There are also future challenges as we continue to reduce debt. Let me recognize here that there are substantial economic and fiscal benefits from reducing debt and maintaining surpluses that we have to always keep in mind. As the back drop for the challenges Treasury faces.

As debt held by the public continues to be reduced, Treasury will continue to need to concentrate the remaining debt in fewer issues to promote liquidity of benchmarks in the market.

The markets will most likely continue to adjust as debt continues to decline, possibly find other benchmark instruments to use in lieu of Treasuries, but the process will not be seamless, nor will it be costless. For example, under CBO's projections in 2009, the estimated $865 billion of stock of debt that is projected to be remaining will be less than the Federal Reserve and State and local governments currently owe combined. In other words, as debt shrinks more and more, all of the claimants in the market that find Treasuries useful for a variety of purposes are going to have to make a substantial adjustment and how Treasury responds to that will be very much worth watching.

Thank you.

[The prepared statement follows:]

Statement of Paul L. Posner, Director, Budget Issues, Accounting and Information Management Division, U.S. General Accounting Office

Mr. Chairman and Members of the Committee.

I appreciate the opportunity to appear before you to discuss managing debt in a time of surplus. As you requested, my testimony today will be drawn from a report we are issuing today to Senate Budget Committee Chairman Pete V. Domenici and you regarding actions taken by the Treasury to manage the marketable debt held by the public in this new fiscal environment.[1]

The federal budget is about to record the first back-to-back budget surpluses in more than 40 years. As a result, federal debt held by the public has declined and, if projected surpluses materialize, it will continue to fall throughout the next 10 years. The Treasury faces the challenge of managing the surplus rather than financing a deficit. To support its management goals, the Treasury has concentrated its borrowing into fewer but larger debt offerings, and targeted its reductions to offset the trend toward generally more costly long-term debt.

In August the Treasury published proposed rules for advanced repurchase of outstanding debt held by the public—a debt "buy-back." These repurchases could require the Treasury to pay a premium since most of the older securities have interest rates higher than those issued today. Since the Treasury has the authority for these repurchases, any premiums would not require an offset under the Budget Enforcement Act, but the payment of a premium would affect the size of the surplus.

As debt declines, the Treasury will face more difficult trade-offs in achieving broad and deep markets for its securities and lowest cost financing for the government. There will be greater pressure on the Treasury to further concentrate debt in fewer issues to maintain deep and liquid markets in benchmark securities. Although markets tend to adjust over time, these changes may not be seamless or without cost.

FEDERAL DEBT HELD BY THE PUBLIC IS DECLINING

As all of you know, fiscal year 1998 brought the first unified budget surplus since 1969. The fiscal year that ends tomorrow also will show a surplus—although we don't know its exact size yet. The Congressional Budget Office (CBO)'s July update showed surpluses continuing throughout the next 10 years.

In fiscal year 1998 debt held by the public fell by about $51 billion, and the Treasury has already reduced the amount of debt held by the public by $68.2 billion in the first 9 months of fiscal year 1999. As figure 1 shows, the debt held by the public reached a peak of $3.83 trillion in March 1998 and dropped by $180 billion, to $3.65 trillion, by July 31, 1999.[2]

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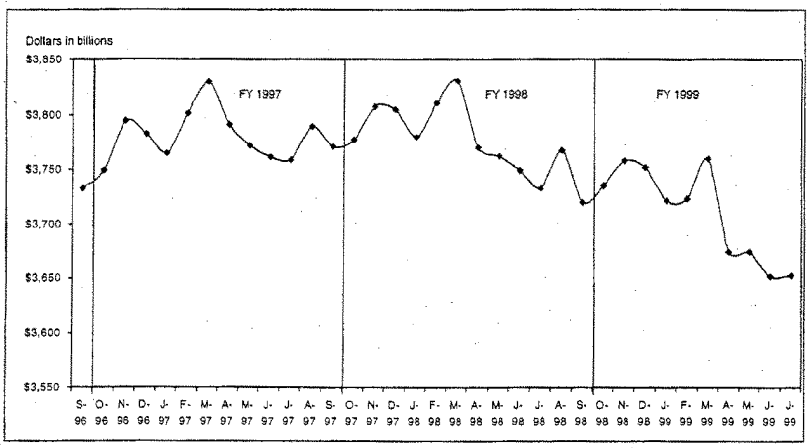
[1] *Federal Debt: Debt Management in a Period of Budget Surplus* (GAO/AIMD–99–270, September 29, 1999). This report is a follow on to a "primer" on federal debt issued in May entitled *Federal Debt: Answers to Frequently Asked Questions—An Update* (GAO/OCG–99–27, May 28, 1999).

[2] This total is net of unamortized premiums and discounts on public debt securities.

Figure 1: Federal Debt Held by the Public, September 1996 through July 1999



Source: Monthly Treasury Statement, Department of the Treasury.

CBO's July projections show debt held by the public falling further from $3.65 trillion in fiscal year 1999 to $0.9 trillion in 2009, assuming current policies.[3]

THE TREASURY'S DEBT MANAGEMENT GOALS AND CHALLENGES

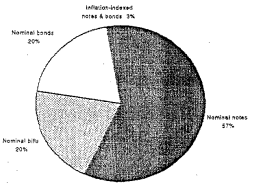
The Treasury's stated goals for debt management have remained the same to date regardless of whether the unified budget is in surplus or deficit: to have sufficient operating cash to meet the government's obligations, to achieve lowest financing cost, and to promote broad and deep capital markets. Although the goals may be the same, the management challenges are not.

Just as deficits lead to increased borrowing, surpluses generally result in the Treasury retiring debt. These two actions are not symmetrical, however. When the debt is increasing, the Treasury is issuing more securities than are maturing and is adding to the amount of debt outstanding. By selecting the instruments with which to borrow, the Treasury can have a greater effect on the maturity profile of the outstanding debt. In contrast, during periods of surplus, the Treasury is retiring more debt than it is issuing. Because the Treasury is not adding to the amount of debt outstanding, the maturity profile is more determined by the maturities of the remaining outstanding debt. As a result, the profile of outstanding marketable debt—both the type of security and when the debt matures—is a significant determinant of how and when the Treasury can reduce debt.

The profile of the Treasury's marketable securities consists of bills that mature in a year or less, notes with original maturities of at least 1 year to not over 10 years, and bonds with original maturities of more than 10 years out to 30 years. As figure 2 illustrates, as of July 1999, 57 percent of the outstanding marketable public debt is nominal (not adjusted for inflation) notes, 20 percent is bills, 20 percent is nominal bonds, and the remaining 3 percent is inflation-indexed notes and bonds.

[3] These budget projections assume compliance with discretionary spending caps on such spending through 2002, that discretionary spending will grow at the rate of inflation thereafter, and that all surpluses are used to reduce debt.

Figure 2: Treasury Bills, Notes, and Bonds as Percentages of Marketable Public Debt Outstanding, July 31, 1999



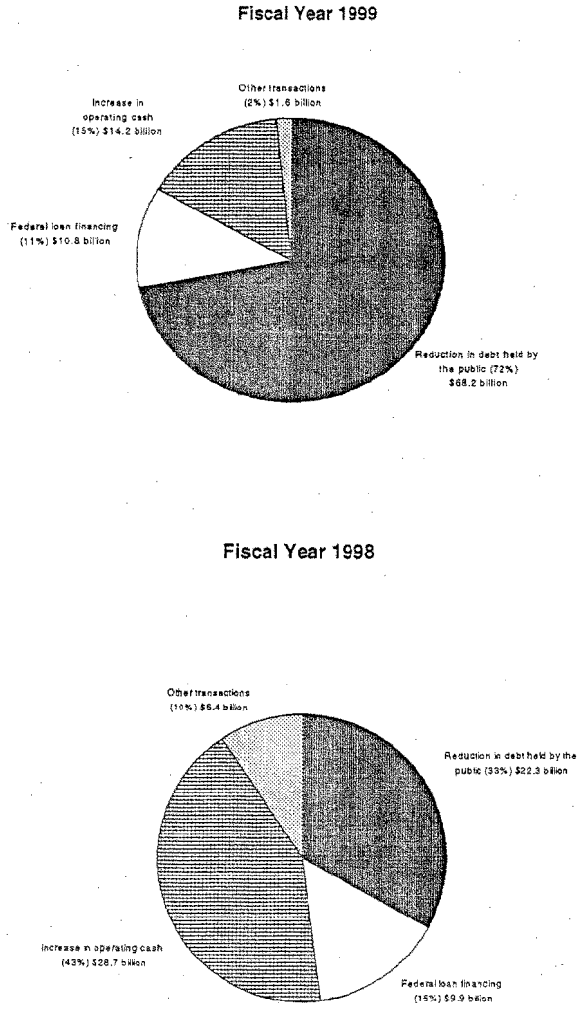
Source: Monthly Statement of the Public Debt of the United States; Department of the Treasury.

THE DEBT MANAGEMENT STORY TO DATE

The "April surprise" that occurred in fiscal years 1997 and 1998 created a situation in which the Treasury suddenly and quickly absorbed unexpectedly high tax revenue, which initially resulted in reductions in short-term debt. Since some bills mature each week, the unexpected cash inflows were used to redeem bills. However, according to a Treasury official, bills were redeemed at such high levels that the liquidity of the bill market was adversely affected and the average life of marketable debt increased modestly—as shown later in Figure 4. Although in fiscal year 1998 total marketable debt declined 3.2 percent, the amount of outstanding bills fell 9.2 percent. If left unaddressed, the shortage of bills and the lengthening of the average maturity of outstanding debt could have increased the Treasury"s cost of borrowing. According to Treasury and Federal Reserve officials, the amount of bills reduced was sufficiently large to cause the market for bills to become less liquid.

After this experience, the Treasury took steps to offset these trends and to better position itself to reduce debt without endangering its management goals. Instead of reducing the size of all issues equally, the Treasury concentrated its borrowing in fewer but larger debt offerings, eliminating the 3-year note and reducing the frequency of the 5-year note from monthly to quarterly in May 1998. In anticipation of a large influx of April tax receipts in 1999, the Treasury operated with a lower cash balance, using cash management bills to ensure adequate cash balances.

Figure 3: Allocation of Unified Budget Surpluses, October to June, Fiscal Years 1999 and 1998



Source: Monthly Treasury Statement; Department of the Treasury.

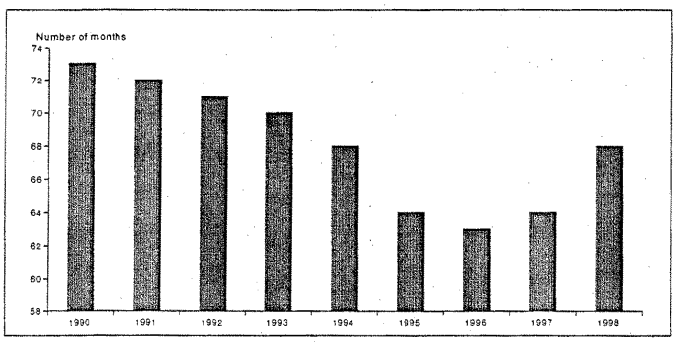
Figure 3 compares the allocation of the surpluses for the first 9 months of fiscal years 1999 and 1998.[4] The higher level of operating cash shown for this period of fiscal year 1998 reflects the fact that this was the first year of budget surplus. As the year continued, the Treasury both reduced outstanding debt and moved to

[4] A budget surplus does not translate dollar-for-dollar into debt reduction because the cash obtained from surpluses can be used to increase cash balances, to finance Federal direct loan and loan guarantee programs, and for other transactions (largely changes to accrued interest and checks outstanding). *See Federal Debt: Debt Management in a Period of Budget Surpluses,* GAO/AIMD–99–270 for more detail.

change the profile by significantly reducing bills, reducing some notes, and continuing to issue bonds and inflation-indexed securities. In fiscal year 1999, however, the Treasury used more of the cash from the surplus to reduce outstanding debt held by the public by operating with lower cash balances. Seventy-two percent ($68 billion) of the fiscal year 1999 unified budget surplus through June 1999 has been used to reduce debt. In contrast, in a comparable period in fiscal year 1998 only 33 percent ($22 billion) of the surplus was used to reduce debt.

The average maturity of outstanding debt has lengthened from 5 years and 3 months in 1996 to 5 years and 9 months in February 1999. The Treasury's actions in fiscal year 1999—reducing relatively more notes than bills—have been aimed at partially offsetting this trend, and in March 1999 the average maturity of outstanding debt stood at 5 years and 6 months. Nevertheless, if the Treasury continued to sell new securities on the May 1999 auction schedule, the average maturity of the outstanding debt would continue to grow. This would happen because the Treasury would redeem short-term securities as they mature and longer-term securities would remain outstanding. Figure 4 shows the trend in average maturity of outstanding debt from 1990 to 1998.

Figure 4: Average Length of Marketable Debt, 1990--1998



Source: Treasury Bulletin, Department of the Treasury.

The Treasury announced in August 1999 that it will reduce the frequency of issuance of 30-year bonds from 3 times a year to twice a year. This will allow the Treasury to continue to concentrate on fewer but larger benchmark issues[5] and to partially counter the current lengthening of the average maturity of outstanding debt. Treasury officials also announced that they are considering reducing the frequency of issuance of 1-year bills and 2-year notes. This move would allow the Treasury to increase the liquidity of the remaining benchmark issues. Continuing to issue new debt across the maturity spectrum and especially in certain benchmark securities is key to supporting the Treasury's current goals of obtaining the lowest financing cost and maintaining a broad, deep market for U.S. securities.

TOOLS TO INCREASE THE TREASURY'S FLEXIBILITY IN MANAGING THE DEBT

As total debt held by the public continues to fall, the Treasury may take other actions to enhance a broad, deep market for Treasury securities and lowest cost financing while still ensuring adequate cash balances. These actions include re-opening the most recent securities issues (selling more of the most recent issue rather than opening a new issue), repurchasing outstanding debt before it matures, and redeeming callable securities as they become callable.

Re-open current issues

The Treasury can increase the liquidity of outstanding issues by continuing to sell debt from the most recent issue (re-opening) rather than opening new issues. This strategy is useful when the Treasury wants to issue a small amount of a given type of security and it determines that the overall cost of re-opening is lower than it would be for new issues. The Treasury uses re-openings regularly for bills and has

[5] The most recently issued Treasury securities, known as "benchmark" issues, are used by other financial services to price their products.

used this tool in the past for notes and bonds. Re-opening allows the Treasury to concentrate its new debt into larger, more liquid issues.

Two other tools—advance repurchase of securities and redeeming callable bonds—would target one segment of outstanding debt by either inviting or requiring investors, respectively, to redeem securities they currently hold. Reducing the amount of outstanding debt through advance repurchase of noncallable and callable securities allows the Treasury to reduce specific, less liquid debt issues and to issue new, more liquid (and generally lower cost) benchmark securities across the maturity spectrum and in greater volume than would otherwise be possible.

Advance repurchase of debt

Repurchasing debt in advance of its maturity is one way for the Treasury to use the cash obtained from budget surpluses to retire outstanding debt. This would allow the Treasury to maintain a higher volume of new, more liquid benchmark securities. Repurchasing high-interest outstanding debt could also reduce the government's interest costs.

On August 4, 1999, the Treasury published proposed rules that would establish a reverse auction—where primary dealers submit offers to sell (rather than buy) a security. Comments on these proposed rules are due on or before October 4, 1999.

Repurchasing debt could necessitate the payment of a premium since most of the Treasury's older securities were issued with interest rates higher than those of securities issued today. Any premium paid to buy back debt might be treated as an interest outlay in the budget year when the securities are repurchased.

Since the Treasury would repurchase using existing legal authority and no legislation would be required, the Treasury's actions would not constitute a "scorable event" under the Budget Enforcement Act. Therefore, even if the premium were shown as an outlay in the budget year when the repurchase occurred, no offsetting cuts would be required although the amount of the surplus would be affected.

Callable bonds

In some years, the Treasury has the option to redeem certain securities before their maturity dates without paying a premium. Before December 1984, the Treasury issued bonds that can be redeemed at face value at the Treasury"s option 5 years in advance of the maturity dates (or on any interest payment date thereafter, after providing 4 months notice). A number of outstanding callable bonds with relatively high interest rates could be redeemed beginning in 2000. There are $87.6 billion in high-interest rate bonds that can be called between May 2000 and November 2009. Redeeming bonds would reduce the amount of debt held by the public and may reduce interest costs.

FUTURE DEBT CHALLENGES

Budget surpluses offer the prospects of significant benefits for both the budget and the economy in the near and longer term. However, surpluses pose challenges to the Treasury's debt management. Declining levels of debt prompt the need to make choices nver how to allocate debt reduction across the full maturity range of securities used.

The stakes associated with debt reduction strategies are considerable. As debt declines, the Treasury faces more difficult trade-offs in achieving broad and deep markets for its securities and the lowest cost financing for the government. Moreover, a wide variety of government and private sector participants both here and abroad have come to rely on Treasury securities to meet their investment needs. Both declining amounts of Treasury securities as well as shifts in their composition affect the interests of these participants. These changes, for instance, may very well affect the use of Treasury securities as benchmarks to price other financial transactions. Although markets tend to adjust to these shifts over time, changes may not be seamless or without cost.

Projections of continuing and increased unified budget surpluses suggest that the challenges to debt management experienced in 1998 and 1999 are a harbinger of more difficult decisions yet to come. The CBO July 1999 baseline projected that debt held by the public would decrease from $3,618 billion in fiscal year 1999 to $865 billion in fiscal year 2009, assuming compliance with discretionary spending caps through 2002, growth at the rate of inflation thereafter, and that all projected surpluses are used to reduce debt. To gain an appreciation of the size of the projected reduction, consider that the level of debt held by the public projected by CBO for 2009 is less than the dollar amount of federal securities owned by the Federal Reserve and state and local governments combined at the end of fiscal year 1998. The particular allocation of securities will be determined by a number of factors but the

comparison above gives a sense of the size of the continuing and more extensive adjustments by both the Treasury and market participants.

As debt held by the public continues to shrink, there will be greater pressure on the Treasury to further concentrate debt in fewer issues to maintain deep and liquid markets. Moreover, the Treasury will need to reassess its issuance of nonmarketable securities such as state and local government securities series and savings bonds. In a similar situation, Canada has begun a pilot program to consolidate its portfolio by buying back outstanding smaller, less liquid issues, allowing a simultaneous auction of new, larger replacement benchmark issues. The U.S. Treasury has taken a number of actions to concentrate its portfolio already and is considering other strategies to enable it to issue new and more liquid issues as overall debt declines, such as buying back outstanding, less liquid debt.

Mr. Chairman, this concludes my prepared statement. I will be glad to respond to any questions you or other Members of the Committee may have.

[Attachments are being retained in the Committee files.]

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Mr. NUSSLE. Thank you, Mr. Posner. You just in a very brief amount of time tried to—it is like drinking out of a faucet, drinking more out of a fire hydrant is what you tried to do, and that is to describe a very complicated situation involving not only our current debt situation and some proposals.

There are many representatives who I have heard describe this, and I probably have been—I could be accused of having done the same thing, describing our debt as similar to a credit card. We say to our constituents, this is the time that we ought to pay back the debt on our credit card, and that is how we describe it.

Could you describe where we are at in a way that I could use to my constituents? I know what you just went through is a very highly technical explanation, but when we are talking about paying back the debt, assuming that there are resources to do so in a cash flow situation, could you describe why debt repayment is not an easy task or can be difficult?

You just described if I am not mistaken a situation saying paying back the debt is not as easy as it may seem. Could you describe that again in maybe a little more layman's terminology so I could redescribe that to my constituents.

Mr. POSNER. Every year there are a certain number of securities that in debt parlance roll over, in other words have to be refinanced. In fiscal year 2000, $1.2 trillion of the over $3 trillion debt will roll over.

Mr. NUSSLE. And these are the T bills that people purchase?

Mr. POSNER. Right.

Mr. NUSSLE. And savings bonds?

Mr. POSNER. That's right. As those roll over, if we just balance the budget, we could simply roll over the issues that are expiring every year and continue with that stock of debt. Possibly in the same type and maturity, possibly not.

Mr. NUSSLE. And the only issue would be how much interest we are paying and that would be assumed in the budget?

Mr. POSNER. Right. And Treasury manages that to some extent as well. What we have now is the supply of publicly-held debt that we are rolling over is less because we have a surplus. In other words, when someone hands you a Treasury bill to pay off, we pay them off and typically we issue more debt to do that. We don't have to do that any more because we have a surplus to pay them off.

We don't have to reach back in the bond market to finance the debt refunding. That is essentially the mechanics of how a surplus works in our system. So we are not issuing as much new debt to finance the debt rolling over. That is mechanically how that works.

Because bills are the most frequently issued bond, when you suddenly find yourself with a large supply of cash and you have all of these bills coming due, you pay them off and you extinguish these bills from the debt inventory, so to speak. So you find yourself with a shrinking supply of bills in the active market. Because bills are useful to the market in a variety of ways, you have a liquidity problem because you are not supplying the demand as much as you used to be doing.

And that is what Treasury found itself presented with in 1998 when it had this April surprise. It had this big influx of cash. Where is it going to park the cash. As you heard this morning, it can park it in TT&L accounts and some other things, but it has to reduce the debt at some point. And when it reduces the debt that happens to be maturing first, you find yourself with a profile that doesn't match your goals. So how do you essentially try to rebalance that debt or retarget that debt so you can shift it more into the direction that the market needs and in ways that help Treasury reduce its costs.

One of the techniques Treasury used is, when some of the longer-term issues have come due this past year, they have not refunded those issues. In lieu of that, they have issued more short term bills to try to enrich that market. They have been trying to more actively manage that profile so they can better arrive at the profile that meets their goals.

Another way to do it is you take all of these outstanding issues that you have issued many years ago that are called off-the-run issues because they have long since stopped being actively traded on the initial market, and you try to find a way to buy them back with the cash from the surplus. You can go out to the market and issue new debt that is more liquid and that gives you a small interest premium as a result, interest bonus, if you will, because they are more liquid.

So it is very much like a balloon in figuring out which part of the balloon you are going to crimp. It is a very complicated kind of a set of tools and approaches that they have to use. Debt buybacks, as you know, are something that corporations use extensively. It is something as we have said some other nations are using. It is the kind of technique that—we see some potential promise from the standpoint of being able to enrich the issues that you want to target for policy purposes. I am not sure how far that goes to addressing your concern.

Mr. NUSSLE. The first half was right on the mark. The second half I think it may be a little more difficult.

Let me ask you this because this question does come up quite often. Is there a level of debt that we should strive to achieve in your opinion and is that zero? Most of my folks back home would say "yes", pay off your debt. Is that the level that we should be achieving, assuming that you can maneuver the balloon as you say, and whether it is a buyback plan or some form of reopenings or

whatever, you can achieve the cash flow that you need, is zero what we are trying to achieve?

Mr. POSNER. I think that is a real fundamental policy question as to how far. Our debt is about 40 percent of our economy. It is higher than it has been in peacetime. For the most part we—we have a chart in our primer here—where we show the debt-GDP ratio since the beginning of our Nation, basically. And debt has only exceeded 30 percent of GDP in wars and depressions, and by and large debt as a share of GDP has hovered at 30 percent or below.

We are clearly above that. We know that we are facing longer-term obligations. As the Comptroller General has testified, we feel that there is a strong case to be made to continue to reduce debt. It has two benefits. No. 1 is, reducing interest cost as a share of the budget. No. 2 is, promoting long-term economic capacity and economic growth which we are going to need to pay off these obligations that we are facing with the baby boom retirement.

So the question is what level is sufficient, and zero doesn't necessarily have to be the right answer. We have noted—and I am often tempted to say maybe we can have this debate when we are around 25 percent of GDP, but I think the direction clearly should be downward.

There are substantial questions about whether we should in fact maintain a market for Treasuries. It is clearly useful for a number of actors in our country.

We are familiar with one nation, Norway, for example, that achieved substantial surpluses with petroleum discoveries, to the point where they could have eliminated their debt market and then some, and they chose to retain a debt market of somewhere around 30 percent of GDP. What do you do with the money? They invested the money in overseas corporations and they have created a petroleum fund with these assets that they are going to be able to call in to finance their baby boom pensions and retirements in the next 30 years. They clearly faced the fork in the road. They decided to maintain a domestic market partly for currency reasons and partly for the reasons that having a domestic debt market is useful.

Mr. NUSSLE. The distinguished gentleman from New York is recognized.

Mr. RANGEL. I was following the Chair's questions and your answers, and I can tell you that Republicans and Democrats in America are just so excited about paying down the Federal debt and reducing our interest payments, and we are just fighting each other taking credit for it.

But after your testimony, it just seems like yes, it is good policy and in the long run it will pay off, but we face serious challenges in buying back debt in times of surplus.

What could be the downside in terms of the challenges that Treasury will face where it goes unchallenged that the less we owe, the less interest, the more moneys we have to invest in other things.

I gathered from your response to Mr. Nussle that you are concerned about the marketplace of debt?

Mr. POSNER. Well, it is partly that. It is partly that we have to pay attention to liquidity not only from the market standpoint, but

also from the Federal standpoint because we gain some cost savings from having more liquid issues.

I don't want to give the impression that we are always looking for the cloud in the silver lining here because clearly surpluses are a very salutary thing. Reducing debt—it just takes active management to achieve these goals that we are trying to achieve, one of which is lowest cost to the Treasury.

And the question that we have to face is what should that profile of debt be and should we proactively manage that in a way that achieves our goals, one of which is lowest cost to the Treasury. Another of which is——

Mr. RANGEL. When you say cost, are you talking about the increased cost in buying our debt before it matures, is that the major cost?

Mr. POSNER. In general it is the whole profile of your outstanding debt. Is your profile reaching a cost level that you think that you can reduce by perhaps shortening the debt. Although there are tradeoffs there because when you shorten your profile, that means that you are rolling it over more frequently, which subjects you to refinancing risks, so there are tradeoffs here.

With regard to this proposal, you could clearly buy back high cost debt and that is good. However, if you pay a premium, which you would, then you really haven't achieved in cost savings. Except when you re-issue more liquid debt, then Treasury does get a marginal cost savings through that.

I think the primary goal of the Treasury buyback program should be evaluated based on its contribution to liquidity and efficient functioning of the markets, which is one of the goals that Treasury sets for itself in this whole set of operations.

Mr. RANGEL. Thank you.

Mr. NUSSLE. The gentleman from Pennsylvania.

Mr. ENGLISH. Thank you. I wanted to follow through on something else you had said to the chairman, Mr. Nussle.

When asked about zero debt, you talked about the GDP to debt ratio. Is it not also true—and stipulating that I believe that we should be buying down the national debt, is it not also true that simply keeping the debt stable over time in absolute terms and growing the economy also has the effect of changing the debt to GDP ratio in a constructive way?

In fact, if you have policies that encourage higher growth rates, you achieve much the same thing, albeit in the short term with a higher interest cost, but you end up from the standpoint of the capital markets still lowering interest rates and stimulating further economic growth?

Mr. POSNER. I think that is probably right. I can ask the other panelists if they want to chime in on that. I think the one thing you have to recognize, debt reduction has two significant benefits. One is to the economy. You are right if you kept the nominal debt the same and grew GDP, then the relative burden would be cut, but there are also fiscal benefits by reducing the share of the budget going for interest. So if you kept debt the same size, you would not necessarily make progress on that front.

Mr. ENGLISH. But you would also expand the tax base and hence the capacity over time. This is a very dynamic situation, is it not?

Mr. POSNER. That is correct.

Mr. ENGLISH. As Alexander Hamilton, still I think our greatest Treasury Secretary, pointed out, there are benefits to having a national debt of a manageable size.

Mr. POSNER. Yes, sir.

Mr. ENGLISH. Is it not fair to say from a cash management standpoint what happened in 1997 and 1998 with the Treasury finding so much cash on hand imposed unexpected costs on the American taxpayer? In summarizing your testimony, is it not fair to say that what happened imposed—because of the liquidity shortage and because of the need to call in so much debt, did it not in effect have some negative consequences for the American taxpayer?

Mr. POSNER. Well, I think it did affect the liquidity of the bill market, and probably at the margin perhaps affected interest costs. But I think again when we evaluate that, we have to recognize that everybody got this one wrong. In other words, nobody anticipated the amount of revenues we were getting in the door in either of those years.

Mr. ENGLISH. I would like to do something unusual in Washington, and that is try to understand this in the abstract and not look for a scapegoat so I am not particularly worried about that. The Treasury has proposed a reverse auction. Is there any alternative method of repurchasing debt that is not currently callable?

Mr. POSNER. Carolyn is going—I know there are other approaches Treasury has used in the past.

Ms. LITSINGER. There are a number of other ways that debt can be bought back. One would be a swap of debt where you exchange one debt security for a new benchmark issue of similar maturity.

Mr. ENGLISH. In this context are any of those alternative methods in your view superior to what the Treasury is proposing?

Mr. POSNER. We really haven't looked at that question at this point.

Mr. ENGLISH. May I call on you to do that, and I would welcome correspondence to myself and to the Committee on that point.

[The following was subsequently received.]

[The following was subsequently received:]

At the request of Chairman Archer, the U.S. General Accounting Office is currently conducting a review of debt management by the the U.S. Treasury and other selected countries which directly addresses Representative English's question. GAO has provided te Committee with several briefings and will issue a final report upon completion of its work.

Mr. ENGLISH. What consequences are there to the Treasury's understanding ratioing of debt issues, the fact that there are fewer debt issues, does that have any impact on capital markets?

Mr. POSNER. It has an impact through this liquidity problem. As the supply of debt shrinks, we are not issuing as much as the demand, and so the potential prices are affected and we are not satisfying that segment of the market.

Markets do adjust but that is a long run phenomenon and we know that adjustment won't be seamless. If we continue down this path, you would think that markets would find other benchmarks, for example, to focus on. But it is principally the liquidity problem that has affected the markets.

Mr. ENGLISH. May I ask one more question and I will make it brief.

Mr. NUSSLE. Without objection.

Mr. ENGLISH. Given that the Treasury has, as I understand it, not budgeted for their proposal on cash management, I would be curious about how it is likely to affect the efforts presumably of both parties to sequester those national revenues that are arising from the payroll tax and use them explicitly for Social Security purposes.

In other words, does this Treasury proposal mean that the Treasury is going to be invading—or creating a deficit outside of Social Security?

Mr. POSNER. Well, the way it is currently accounted for and the way it would affect the actual cash position of the Government is, in the current year, it would be a reduction in the surplus.

Now, whether it is a reduction in Social Security surplus depends if there are enough on-budget surpluses to draw from for this purpose or not. If there aren't, then it would be a call on that portion of the surplus. However, over time, if we do buy back higher-cost securities, we are going to——

Mr. ENGLISH. And savings——

Mr. POSNER [continuing]. And savings on the tail. When you look at a 10-year perspective, you could probably judge it to be neutral. Except for the premium, the financing of the premium, as Chairman Archer pointed out earlier, would be a slight additional cost that would have to be financed.

Mr. ENGLISH. Thank you.

And thank you for the opportunity, Mr. Chairman.

Mr. NUSSLE. Are there other Members who wish to ask questions of this panel? If not, thank you, panelists, for your testimony and you are excused. We appreciate your testimony today.

The final panel for today's hearing on the Treasury's debt buyback proposal includes Dr. John H. Makin, resident scholar of the American Enterprise Institute; and Charles H. Parkhurst, vice chair, Government and Federal Agency Securities Division, Bond Market Association and managing director of Salomon Smith Barney of New York.

We appreciate you gentlemen coming here today to give us testimony on this issue and we will recognize Dr. Makin first, and your full testimony, without objection, will be inserted in the record and you can feel free to summarize your testimony at this time. Dr. Makin.

STATEMENT OF JOHN H. MAKIN, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. MAKIN. Thank you, Mr. Nussle, and Mr. Chairman and Mr. Rangel and Members of the Ways and Means Committee. It is a pleasure to be back before you, after an absence of several years, to testify on the Treasury's proposal to buy back some of the U.S. Government's outstanding debt before it matures.

Any attention paid to careful management of the U.S. Government's debt is, of course, commendable. As one of the Members has already noted, Alexander Hamilton, the first Secretary of the Treasury, remarked in his report on the public credit issued in Jan-

uary of 1790 that America's national debt could be a blessing to the country. And I think some of the discussion today about the benefits of having a well-managed stock of outstanding debt was well anticipated by Alexander Hamilton.

With Hamilton's principles in mind and with the knowledge that the current stock of U.S. Government debt held by the public stands at about $3.6 trillion or a modest 41 percent of GDP, I see no urgency about the overall size of the debt. Indeed, CBO projects that over the next decade, debt held by the public could drop to about 6.4 percent of GDP, based on some assumptions about the economy and the course of government finance.

Having said that, of course, we all must remember the great sense of alarm with which prospective U.S. Government finances were viewed during most of the eighties. I would argue, and have argued at more length in the attached American Enterprise Institute publication about the determinants of interest rates, that the concerns about America's debt buildup were overdone while, simultaneously, the optimism about the future course of debt may also be overdone. Basically, the argument suggests that there is little relationship between the level of interest rates and normal oscillations in the fiscal stance of governments, of advanced industrial countries like the United States and Japan, and that the proper attention of fiscal policy should be directed primarily to collecting taxes in the way least costly to the economy and on a scale that finances consistently a modest-sized Federal Government.

The Treasury's debt buyback proposal is really about the management of a given stock of debt rather than about its absolute level or its level relative to GDP. The Treasury's proposal aims to improve liquidity in the Treasury market and amounts to debt management of the type that most corporations perform on their balance sheets.

And as I listened to the testimony this morning, I was trying to think of a way to characterize the role of this proposal in the context of overall fiscal policy. I guess I would do it something like this.

If I were a child who had been deprived of candy for a year or several years, paying down the debt is the equivalent of being able to go out and buy some candy. Very attractive. Lots of fun. It raises lots of choices.

But the Treasury's debt management proposal is really about what size packages of candy you should buy. In other words, it is not about the level of the debt.

We are all happy to be running down debt. The Treasury is addressing what I would generally call, both as a public policy expert and as a participant in the financial markets, a "peripheral issue," one that the Treasury can and does manage pretty much on its own. And there are some technical issues raised that I just want to briefly touch on.

The Treasury's debt management proposal would involve the purchase of some illiquid issues, particularly longer maturities financed, in turn, by the issue of shorter term government debt. The reason that there are going to be longer maturities is simple. If you have got a 1-year instrument, why worry about a liquidity issue? It is going to mature at par, so it is not an issue to be bought back

prior to maturity. The fact that most of the issues that the Treasury would be buying back would be higher yield issues of longer maturities is simply due to the fact that interest rates have been going down for the past 25 years. So naturally most of the issues that the Treasury would contemplate repurchasing would be issues with higher coupons of longer maturity.

The debt isn't generally callable and can't be retired before maturity at par. It has to be purchased in the marketplace at prices that fully reflect the unusually high coupon. For example, U.S. Government bonds that mature in November 2006 carry a market price of about $1,432 per unit, well above the par value of $1,000 per unit. This reflects the fact that investors who purchased 30-year bonds yielding 14 percent at a time when U.S. inflation was high and the finances of the U.S. Government were less sound than they are today have reaped a windfall gain from their purchases of U.S. Government bonds. That is because now U.S. Government bonds of comparable maturities yield between 5½ and 6 percent and so the investor has to be compensated with the higher premium that he would be giving up.

We should not do away with the callable feature of Treasuries because such a future makes them more attractive. We have already covered the fact that above-bar buybacks would reduce the surplus in a given year. I think it is important to realize that buybacks don't provide any net benefit in terms of overall outlays unless the Treasury is issuing short-term debt to buy back long-term debt and interest rates fall in a way that is not currently anticipated by the market.

In closing, let me say that the American government currently enjoys one of the soundest fiscal positions among industrial countries, and in the world for that matter. This may be the time simply to leave well enough alone and concentrate instead on constraining the growth of spending while simultaneously restructuring the tax system to reduce the cost of collecting revenues. Indeed, sound arguments could be made to move to lower and uniform tax rates and that would probably benefit the economy more over the next decade than would the reduction of the national debt to 6 percent of GDP. Certainly the benefits of such measures would be greater than efforts to rearrange the debt structure of U.S. Government securities outstanding.

Thank you.

Mr. NUSSLE. Thank you.

[The prepared statement follows:]

Statement of John H. Makin, Resident Scholar, American Enterprise Institute

Mr. Chairman, members of the Ways and Means Committee, thank you for providing me with the opportunity to testify today on the U.S. Treasury's proposal to buy back some the U.S. government's outstanding debt before it matures.

Any attention paid to careful management of the United States government's debt is, of course, commendable. Alexander Hamilton, the first Secretary of the Treasury, remarked in his Report on the Public Credit issued in January of 1790, that America's national debt could be a "blessing" to the country. By this he meant that the United States could be well served by maintaining even a large outstanding stock of debt which was well managed and provided lenders with a reliable store of value providing a fair rate of return. More broadly, Hamilton reminds us that U.S. Treasury debt management should be aimed at minimizing the government's borrowing costs for a given stock of debt and not necessarily at eliminating the debt.

With Hamilton's principles in mind, and with the knowledge that the current stock of U.S. government debt held by the public stands at about $3.6 trillion or a modest 41 percent of GDP, I see no urgency about the overall size of the debt. Indeed, CBO projects that, over the next decade, debt held by the public could drop to about 6.4 percent of GDP based on some reasonable assumptions about the economy and the course of government finance. Having said that, of course, we all must remember the great sense of alarm with which prospective U.S. government finances were viewed during most of the 1980s. I would argue, and have argued at more length in the attached American Enterprise Institute publication about the determinance of interest rates, that the concerns about America's debt buildup were overdone while, simultaneously, the optimism about the future course of debt may also be overdone. Basically, the argument suggests that there is little relationship between the level of interest rates and normal oscillations in the fiscal stance of government's of advanced industrial economies like the United States and Japan and that the proper attention of fiscal policy should be directed primarily to collecting taxes in the way least costly to the economy and on a scale that finances consistently a modestly-sized federal government.

The Treasury's debt buyback proposal is really about the management of a given stock of debt rather than about its absolute level or its level relative to GDP. The Treasury's proposal aims to improve liquidity in the Treasury market and amounts to debt management of the type that most corporations perform on their balance sheets.

The Treasury's debt management proposal would involve the purchase of some illiquid issues, particularly longer maturities financed in turn by the issue of shorter-term government debt. The fundamental constraint on a benefit to the U.S. government from this debt management is the fact that virtually all of U.S. government debt is not callable. That is, the debt cannot be retired before maturity at par. Rather, it must be purchased in the marketplace at prices that fully reflect the unusually higher coupon level that such debt may carry. For example, the U.S. government bonds that mature in November of 2006 carry a market price of $1432 per unit, well above the par value of $1,000 per unit. This reflects the fact that investors who purchased 30-year bonds yielding 14 percent at a time when U.S. inflation was high and the finances of the U.S. government were less sound than they are today have reaped a windfall gain from their purchase of U.S. government bonds. That is because now U.S. government bonds of comparable maturities yield between 5.5 and 6.0 percent and so the owner of a U.S. government bond yielding 14 percent is not going to yield up his high-yielding bond for anything less than a price that fully reflects the present discounted value of that higher yield, in this case an extra $432 per $1000 of face value.

The facts outlined here are not meant to suggest any modification in the non-callable feature of Treasury securities. Such a non-callable feature makes the bonds more valuable to investors who are willing to purchase them when circumstances such as larger supply or rising inflation make for a higher yield. The non-callable feature on long-term government debt rewards those lenders who were willing to purchase Treasury bonds at a time when they were decidedly out of favor. Those are the kinds of investors one wants to keep in the universe of potential customers for U.S. government debt. The fact that, although U.S. government debt rose rapidly during the 1980s while interest rates were falling, is testimony for the benefits of sound debt management, particularly the benefits of bringing down inflation and to eventually aligning the growth of revenues and outlays so as to stabilize and ultimately to reduce the ratio of government debt to GDP.

The way the U.S. budget is scored, the premium paid to retire debt with high coupons (interest rates above current market interest rates) would count as an outlay and therefore would raise the measured budget deficit during the year in which such debt management was undertaken. This, however, need not constitute a major argument against the proposal since the premium paid is actually a pre-payment of higher coupons in future years and the impact on the present value of overall payments to serve the national debt would be close to zero.

In summary, if the purpose of the Treasury's proposed debt management initiative is to reduce the present value of debt service outlays on the national debt, it is unlikely that much will be accomplished. In effect, the Treasury, by issuing short-term debt to buy back long-term debt, is betting on a fall in long-term interest rates that is *not currently anticipated by the market.* If long-term interest rates were to drop, say from the current level of 6.0 percent to 3.0 percent, the Treasury's proposed swap of short-term for long-term debt could only be done on even less favorable terms than are available at today's interest rates. Therefore, the Treasury, by purchasing high-yielding long-term debt at less of a premium would, after the fact, have saved taxpayers some money. But since the Treasury would probably be the

first to admit that it is no better at forecasting interest rates than anyone else, the benefits of the buyback on a forward looking basis, specifically in terms of debt management costs, would be close to zero.

The American government currently enjoys one of the soundest fiscal positions among the industrial countries and in the world for that matter. This may be the time, simply, to leave well enough alone and concentrate instead on constraining the growth of spending while simultaneously restructuring the tax system to reduce the cost of collecting revenues. Indeed, sound arguments could be made that a move toward lower uniform tax rates could benefit the U.S. economy more over the next decade than would reduction of the national debt to 6.0 percent of GDP. Certainly the benefits of such measures would be greater than efforts to rearrange the debt structure of U.S. government securities outstanding.

[An attachment is being retained in the Committee files.]

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Mr. NUSSLE. Mr. Parkhurst, your testimony in its entirety is included in the record. You may feel free to summarize. Welcome.

STATEMENT OF CHARLES H. PARKHURST, VICE CHAIR, GOVERNMENT AND FEDERAL AGENCY SECURITIES DIVISION, BOND MARKET ASSOCIATION, AND MANAGING DIRECTOR, SALOMON SMITH BARNEY, NEW YORK, NEW YORK

Mr. PARKHURST. Thank you very much and good morning. I am pleased to be here to discuss the Bond Market Association's views on the Treasury Department's buyback proposal. The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities both domestically and internationally. Our membership includes all major dealers in government securities including all 30 primary dealers. For 15 years, my career has been focused on the government securities market. I have seen the size of the market grow substantially over the years as persistent deficits cause Treasury issues to swell.

Now we are at a time of unprecedented surpluses and the question before us now is to how to most effectively retire the Government's debt. Under some projections, the Government securities market will disappear entirely in the next 15 years. The Association believes that a properly structured buyback program is the best way to retire the Government's debt and will—I repeat, will reduce interest expense for the American taxpayer. Beyond that, it is vital that to the extent possible, we maintain the premier role of the government securities market as a global benchmark. After all, it is quite possible that the Government may again become a net borrower sometime in the future.

My written statement discusses in detail the benefits to Federal taxpayers in the economy as a whole of maintaining an active and liquid on-the-run market for Treasury securities. Rather than outline my entire written statement, I would like to discuss what I believe is the biggest obstacle to the success of a buyback program; that is, the budgetary accounting of premiums and discounts on outstanding government securities purchased by the Treasury in the open market.

I was going to go through the details of the budgetary accounting, but my predecessors have done that ad nauseam, so I am going to skip over that part and jump to the consequences of the way the Government accounts for buying securities back at a premium.

Almost all the securities which are likely candidates for buyback are traded premiums. That means in the current budget rules, most buyback transactions would have the effect of reducing the surplus. This has several implications. First, it could limit the size and the success of the buyback program. Treasury may be essentially unable to buy back many securities because of negative budget consequences.

Second, it could prevent Treasury from buying back those securities which offer the largest interest cost savings for the Government over the long haul, in other words, those which carry the highest coupon rates. Finally, to the extent that Treasury does buy back premium or discount securities, these transactions would result in annual budget surpluses larger or smaller than otherwise would be the case.

The most obvious solution to this problem would be to change or clarify the budget accounting rules so that any expense or savings associated with buying back securities could be spread out over the years that the securities would have been outstanding. This method is used by other sovereign nations that have conducted buybacks.

We sincerely believe that this accounting issue, as arcane as it sounds, could be a serious impediment to the buyback program. We urge all parties involved in the discussion over buybacks to work together to address this issue. If the accounting cannot be changed, it is crucial to the program's success that Treasury not be driven by the short-term budgetary impact of their purchase decisions. If Treasury were to skew their purchases toward low-priced bonds, the impact on the liquidity of the entire Treasury market would be severely impaired. I simply can't emphasize that point enough.

Finally, I would like to spend a minute to talk about the timing of debt buybacks. Treasury plans to issue—to use debt buybacks as one tool to help them manage their cash balances. That has been discussed at length as well. While we feel this is a useful attribute of debt buybacks, we also feel that a regular buyback schedule is crucial to the ultimate success of the program. Just as regular, quarterly Treasury issuance maximizes investor focus on the auctions, we feel a regular schedule of buybacks would yield the greatest participation and therefore the most advantageous pricing for the Treasury.

And finally I want to spend a few minutes talking about something that was a little bit confusing in prior testimony, and that is, will the Government actually save money from conducting debt buybacks? And apart from the issue of adjusting the average maturity, which I think should be put aside as a separate issue, it is very clear to market participants that you can quantify the interest rate savings very directly. Let me give you one simple example of that.

Right now the Treasury can issue 10- and 30-year bonds at approximate yields of 5.9 and 6 percent, respectively. They could simultaneously issue those bonds and purchase 20-year bonds, in other words, bonds that exist right in between a maturity spectrum, at approximately 635 or 640. So effectively what the Treasury would be doing is retiring 20-year bonds, issuing 10- and 30-

year bonds, doing nothing to the average maturity and very easily quantify the interest rate savings.

To put it in perspective historically, the spreads that I just alluded to are literally at their widest point over the last 15 years I have been following this market. So not only can the Treasury save money, but they can save more money by implementing the program now than they could have in the last 15 years.

Thank you.

[The prepared statement follows:]

Statement of Charles H. Parkhurst, Vice-Chair, Government and Federal Agency Securities Division, Bond Market Association and Managing Director, Salomon Smith Barney, New York, New York

The Bond Market Association appreciates the opportunity to comment on the Treasury Department's debt buyback proposal and on Treasury debt management in general. The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally.

Our membership includes all 30 primary dealers in government securities as recognized by the Federal Reserve Bank of New York, as well as hundreds of other securities firms and banks that participate in the government securities market. We take a very active interest in issues related to federal government finance and the Treasury securities market. A liquid and efficient government securities market is in the interest of securities dealers and, much more importantly, in the interest of the federal government and U.S. taxpayers. The Ways and Means Committee's continued attention to Treasury debt management issues is welcome and appreciated. We commend you, Chairman Archer, for calling this hearing, and we are pleased to present our views.

We find ourselves today in an enviable position. We are assembled this morning to discuss the most efficient and desirable way for the Treasury Department to retire the debt of the United States. Just a few years ago, it was virtually unthinkable that the fiscal deficit would be eliminated and that the entire federal debt held by the public—nearly $3.3 trillion—would be expected to be retired entirely in our lifetimes. The question now for the Treasury Department and for members of this committee is how to retire the debt in the most orderly way without threatening the efficiency and liquidity of the market.

THE GOVERNMENT SECURITIES MARKET

The U.S. government securities market is widely acknowledged as the most liquid and efficient securities market in the world. Daily trading volume in Treasury securities totals in the hundreds of billions of dollars. Trading spreads—secondary market dealer transaction costs-are razor thin. Treasury securities are held by a large and diverse group of investors, including individuals, state and local governments, corporations, pension funds, insurance companies, central banks and others. The government securities market is the model of market efficiency around the world, and the market's efficiency and liquidity provide several important economic benefits.

Low-cost government financing—The market's efficiency allows the federal government to issue approximately $2 trillion per year in bills, notes and bonds at reasonable terms. Considering that approximately $5.6 trillion of Treasury debt is outstanding, if the government incurred an overall cost of borrowing just 1/100th of a percentage point (1 basis point) higher, taxpayers would face an additional interest expense of $560 million per year. Clearly, maintaining an efficient new-issue market for Treasury securities is in the interest of taxpayers.

A "reference" interest rate market—The U.S. Treasury securities market is the interest rate benchmark for all the other U.S. debt markets. Corporate, municipal and federal agency bonds and mortgage—and asset backed securities are all priced by their "spread to Treasuries," i.e., their yield above comparable government securities, which allows for much more efficient pricing. This "reference yield curve" allows borrowers other than the federal government—corporations, states and localities, government-sponsored enterprises and, indirectly, homebuyers and consumer borrowers—to access capital at the lowest possible costs for several reasons. First, the liquidity of the Treasury market allows market participants to hedge risk associated with positions in other types of bonds. Second, because Treasury securities are considered to be free from credit risk, it is easier to evaluate debt instruments such

as corporate bonds and mortgage-backed securities against the risk-free rates in the Treasury market.

A vehicle for implementing monetary policy—When the Federal Reserve seeks to adjust interest rates or the money supply, it acts principally through the government securities market. On an almost daily basis, the Federal Reserve Bank of New York buys or sells Treasury securities under repurchase agreement contracts. Less frequently, the Fed buys or sells Treasury securities outright. The Fed's counterparties are a network of securities dealers known as "primary dealers." The Fed uses the government securities market principally as a monetary policy tool because of the market's efficiency and liquidity.

The efficiency of the government securities market is best observed by examining "on-the-run" Treasury securities. On-the-run Treasuries are the most recently issued series of bonds in each regularly auctioned maturity. The vast majority of secondary market trading in government securities takes place in these benchmark issues. The on-the-run market is supported by a dependable and well-publicized schedule of Treasury Department auctions. This regular and predictable schedule is necessary because Treasury often sells tens of billions of dollars of bills, notes or bonds over short periods of time. Market participants depend on a regular auction schedule to plan for the efficient placement of large volumes of securities. The Treasury Department's financing is motivated by a single factor: the government's cash position. The Treasury Department must ensure that the government's cash on hand remains at levels high enough to ensure that obligations are met, but not so high that taxpayers incur needless interest expense. Much of the Treasury Department's new securities issuance is for the purpose of "rolling over," or refinancing, outstanding debt that comes due.

In recent years, as the fiscal budget deficit has shrunk and then disappeared altogether, the government's cash needs have diminished. Consequently, the Treasury Department has reduced the sizes of securities auctions and eliminated certain sales entirely. As the budget surplus continues to grow, the Treasury Department could simply continue the same strategy of curtailing auction sizes for new securities. However, we believe that the sizes of securities auctions would eventually fall to the point where efficiency suffers, and the government would pay a higher interest rate on its borrowing than otherwise. In addition, secondary market trading volume in on-the-run Treasury securities would fall, and we would begin to see the loss of economic benefits associated with an active and liquid secondary market in government securities. If budget surpluses continue to rise at the rate of current projections, these negative effects will inevitably occur. Indeed, if the projections of the Congressional Budget Office and others hold true, the government securities market will disappear entirely in about 15 years. However, through the effective use of buybacks, we anticipate that we can maintain the vibrancy—and the associated economic benefits—of the on-the-run Treasury market for much of that time.

THE TREASURY DEPARTMENT'S BUYBACK PROPOSAL

On August 5, the Treasury Department published a proposed rule encompassing the terms of a Treasury securities buyback program. In general, The Bond Market Association supports the effective use of buybacks as a means of managing the government's debt position. Buybacks will allow Treasury to maintain sizable new auctions while retiring outstanding debt in the most efficient manner possible. We are in the process of drafting a detailed comment letter on the Treasury proposal which we will file by the October 4 deadline. We would be happy to share our comments with the committee members when our letter is final. For today, we will touch on several key points.

Premium Versus Discount Coupons

When a debt security carries an interest rate, or "coupon," higher than that currently being demanded by market investors, that security is said to trade "at a premium." Its price is higher than its par amount, or face value. Conversely, when a debt security carries a coupon lower than that currently being demanded by market investors, that security is said to trade "at a discount." Its price is lower than its par amount. Because current market interest rates are low relative to the past 15 years, most outstanding Treasury notes and bonds trade at a premium. Moreover, many "seasoned" Treasury securities—securities that have been outstanding for some time and which are no longer on-the-run—trade "cheap," i.e., their prices are lower and their rates of return are higher 4 than one would expect considering the on-the-run market. This occurs for several reasons.

First, the largest volume of outstanding securities in the hands of trading market participants is in on-the-run issues. As on-the-run issues age, a larger volume of

these issues finds its way into the portfolios of buy-and-hold investors and out of the hands of active traders. As securities become less actively traded, dealers price them less aggressively. Once an issue loses its status as on-the-run issue, its rate of return relative to similar issues rises slightly—it becomes cheaper—because it becomes less actively traded. Second, certain securities, those with 15 years or longer to maturity, are eligible for delivery against the Chicago Board of Trade's Treasury bond futures contract, a very active hedging and trading instrument. As long-term bonds age to the point where they have less than 15 years to maturity and are no longer deliverable against the T-bond contract, they are priced less aggressively and carry a higher rate of return, i.e., they are cheaper. Third, off-the-run bonds with times-to-maturity shorter than 30 years—the time to maturity for the actively traded, on-the-run 30-year bond—tend to trade more cheaply than securities whose times-to-maturity are closer to 30 years.

In implementing a buyback program, the Treasury Department will likely find it most efficient to purchase securities with a variety of maturities and coupons. It is our view that a buyback program where certain issues are bought in their entirety and other issues are wholly untouched could cause market disruption. Moreover, it would be to Treasury's advantage to buy seasoned securities whose prices are cheap, thereby achieving the maximum interest cost savings. Unfortunately, federal budget rules may discourage or prevent the Treasury Department from buying certain premium securities. This is, we believe, a potentially serious impediment to a successful buyback program.

Accounting Issues

According to our understanding of federal budget and accounting rules, if the Treasury Department buys back a security at a price above par, or face value, the excess amount above par is accounted for as interest expense in the year the security is bought. Consider, for example, outstanding bonds with a total face value of $100 million which, because they carry an interest rate above the current market, sell at a price of $125 million. The $25 million difference approximately represents the difference between interest payments on $100 million of bonds at current rates and the higher interest payments on the bonds that are actually outstanding. If Treasury bought these bonds in a buyback transaction, the $25 million excess over face value would be accounted for as interest expense at the time the purchase takes place. Federal accounting rules do not allow Treasury to amortize the $25 million expense over the time that the bonds would have been outstanding. Conversely, for securities bought at a discount, the price amount below face value would offset other interest expense incurred during the year. This timing issue is critical in calculating the government's current-year fiscal position. If Treasury undertook the buyback in the above example, the budget surplus in the year the buyback took place would appear $25 million smaller. If Treasury bought securities at a discount, the budget surplus could appear larger.

The negative budgetary effects of buying back securities priced at a premium could seriously hamper the success of the buyback program. For decades, Treasury staff has been apolitical in its debt management practices, and we have every reason to believe that it will continue to be. In addition, Treasury uses sophisticated financial management tools in making debt financing decisions, and we expect that the same level of sophistication would be applied to the buyback program. However, given the unique nature of the budgetary effects associated with buybacks, it is conceivable that Treasury could be influenced to buy back only those securities which trade at a discount to face value. This would hinder the program because, first, there are relatively few discount securities in the secondary market. Second, concentrating buybacks only on certain securities could cause market anomalies and could cause the prices of some securities to suffer.

Finally, Treasury could be effectively discouraged from buying those securities that would generate the greatest interest cost savings to taxpayers. Treasury has indicated that the buyback program will be used to shorten the average maturity of the government's debt. For various technical reasons, it is likely that Treasury will concentrate its buybacks on outstanding issues scheduled to mature after 2014. Of the outstanding Treasury debt maturing after 2014, approximately $248 billion would be likely candidates for buybacks. Virtually all of this $248 billion in outstanding debt trades at premium prices. In fact, this debt has a current combined market value of approximately $308 billion. This $60 billion difference—$248 billion of debt at a value of $308 billion represents the "front-loaded" interest expense that the government would incur if these outstanding securities were bought back over the next ten years. Of course, the interest savings to taxpayers over the remaining 15 years of indebtedness would be even higher. It is clearly in the federal govern-

ment's interest to buy back these outstanding securities. However, current accounting rules could make that prospect practically difficult.

In addition, as a result of this accounting issue, the true size of the budget surplus could be exaggerated. In order to achieve a larger surplus, Treasury could simply buy back discounted securities and inflate the size of the surplus. This practice could have serious implications if, for example, Congress were to enact tax cuts that were contingent on meeting certain budget surplus targets. Conversely, Treasury could concentrate its buybacks on premium securities in order to make the surplus appear smaller. The most obvious solution to this problem would be to change federal budget and accounting rules so that when Treasury bought back securities priced at a premium, the excess price over face value could be amortized over the period that the securities were expected to be outstanding. The same principle in reverse would apply to securities bought at a discount.

Other Issues

Our comment letter on Treasury's buyback proposal will also likely address other issues. We expect to recommend, for example, that reverse auctions take place on a regular, predictable schedule with announcements made in reasonable advance. In addition, we may also recommend that Treasury exercise caution in selecting which securities to buy back so as not to magnify any technical or liquidity issues that may be prevailing in the market at the time. We will also likely comment on the settlement of buy-back transactions and on other technical issues.

SUMMARY

The Bond Market Association believes that in general, a program of regular buybacks represents the preferred method for retiring federal debt. A successful buyback program would help to preserve the efficient auction program for new Treasury securities and would help to keep the government's financing costs as low as possible. It would also help preserve the liquid "on-the-run" secondary market in Treasury securities, thereby maintaining the important economic benefits that market provides. Our principal concern regarding buybacks involves the accounting treatment of premiums and discounts for securities bought by Treasury in the public market. If left unresolved, this issue could threaten the success of the program.

We appreciate the opportunity to present our views, and we look forward to working with the Treasury Department, the Federal Reserve and, of course, this committee as this issue progresses.

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Mr. NUSSLE. Thank you very much for your testimony.

First of all, we love discussing budgetary scoring details; around here, you can never discuss them ad nauseam. We appreciate the opportunity to continue that discussion. And, in fact, that is where probably a lot of this will end up in making any kind of final decision about what is good policy and bad policy is, how in fact it scores, because as I understand Dr. Makin's testimony, one of your—please correct me if I misunderstand this—basically what you are suggesting is that the debt buyback plan will only generate savings if interest rates fall, which makes some logical sense. And I may have heard a conflict between the two of you on that statement, and I guess I would just like to hear you talk about what was just discussed.

You are basically saying, unless they fall, the plan really doesn't work; is that correct? And could you explain that a little further? Then I would like to hear at least a little bit of rebuttal from Mr. Parkhurst.

Mr. MAKIN. I don't think there is a real difference here.

I think that Mr. Parkhurst's testimony was referring to the shape of the yield curve and some liquidity premia on some off-the-run issues. I am saying that if you are going to buy buyback debt, it is going to be longer term debt. It is probably going to be selling

at a premium to the market, and that is simply because there is not much point in buying back short-term debt—it will mature and run off at par, why bother; that is simple debt management—and second, because interest rates have been going down since 1979, again typically anything you are going to buy back will have interest rates above market rates and so will have to be purchased at a price above par.

The point I am making is straightforward. You go to somebody who owns, let's say, a bond, a government bond that is bearing 14 percent that is going to mature in 2006 and look up its price in the Wall Street Journal. That bond is now selling for $1,432 per $1,000 face value. The person is saying, look, I am going to pass up a 14 percent interest rate between now and 2006; you have got to pay me now.

So the Treasury would essentially have to pay now the present value of the forgone interest on that bond; and they could do it by borrowing short term. And as has been noted, the budget procedure, I believe, requires that the $432 per bond be scored as an outlay.

The point that I am making is, look, why go through all that? The present value of interest costs to the Treasury isn't going to be better unless there is an unexpected drop in interest rates. That is, if interest rates dropped to 3 percent and you retired 6 percent debt, you retire debt when market rates are 6 percent, the Treasury has made a gain.

I don't think the Treasury is proposing that they can forecast interest rates. I think the Treasury is strictly talking about cash management here. I don't really think the Treasury is talking much about interest savings other than very small interest savings from cleaning up their balance sheet and getting rid of some off-the-run issues. Again, these issues become less intense with the passage of time. With an illiquid issue—for example, for my daughter, I bought some off-the-run Treasuries and got a slightly higher rate of return because I know that if I needed to sell them before they matured, somebody on a bond desk would give me a real haircut. The Treasury is trying to alleviate that problem, saying, let's neaten up our balance sheet.

The reason I bought it is because I am going to hold it till it matures and matures at par. There is no issue of transactions cost selling it beforehand.

Again, that is why I go back and use the candy bar analogy. The surplus is having candy to buy. This is a very technical issue which the Treasury can manage, and it is akin to, should I buy a 2-ounce package of candy or a 4-ounce package of candy? It is not a big issue. It has virtually no budgetary implications other than those that are driven—and I understand that this is important—by the way in which you score the premium that has to be paid for issues with higher interest rates.

Mr. NUSSLE. Mr. Parkhurst.

Part of the reason I ask the question, there is just about no one that I am aware of forecasting a drop in interest rates any time soon. Your example makes sense when you are talking about from 6 to 3. Certainly that makes sense. But there is no one who is suggesting that kind of drop. In fact, an increase is what appears to

continue to be on the horizon at least. So that is the reason I ask the question.

Mr. PARKHURST. I think it is important, as I said, to separate out two different issues. To the extent that the Treasury wants to push the average maturity of their debt down, they are in effect making a better interest rate relative to doing nothing with the average maturity.

Now, it has crept higher over the past year or so, so maybe they are justified in using debt buybacks as a mechanism for pushing it down back toward what they perceive to be neutrality. Maybe they think it is too long right now and this is one way to get back toward neutrality. That is one issue. I would separate that issue out from the other issue.

He talked about the 14s of 11, callable 06, and he is right, that issue will mature at par, so why bother to call to buy it back. The reality of it, the Treasury, if they issue an on-the-run security maturing in 06—in other words, the same maturity date when this one comes due—they can do so at a substantially lower yield than the securities exchange in the marketplace. That is the liquidity premium that he referred to earlier.

While it is true that this issue will over the next 7 years naturally roll off, the Treasury can actually say, "Well, I perceived there to be significant interest savings over that 7-year period by repurchasing it today and doing nothing to the average maturity mix." That issue probably has a present value savings in the neighborhood of 2½ to 3 percent if you look at present value terms. So for every 100 million that the Treasury bought back, they would save $2.5 to $3 million in present value terms; and that is easy to quantify, and I have my research department behind me if you want to go through the numbers.

If you look at it in the longer part of the curve, in 2015 and longer, if you look at the Treasury maturity structure, it is kind of interesting. They, Treasury, stopped issuing callable bonds in 1985, and prior to that, all 30-year issues were callable after 25 years. There is a gap in the maturity structure between, effectively, 2010 and 2015. Since projections are that the Treasury debt will go down close to zero in 15 years, it seems to make most sense for Treasury to start repurchasing securities that mature after 2015.

If you look at the present value savings I just referred to in the 14s of 11, that was referred to earlier, those present value savings are on the order of 5 percent. So for every 100 million repurchased, $5 million is saved on a present value basis. Once again, that is a very quantifiable savings. We have numbers going back 10 or 15 years in the Government securities market.

This number used to be on the order of 2½ to 3 percent, historically. So the present value savings available to the Treasury has doubled. And the reason it has doubled primarily is an overhang from the liquidity problems that existed in the fixed income markets last fall. I am sure you all remember the long-term capital rescue that was orchestrated by the Fed. We are still seeing the overhang from that episode, and one of the results of it is the significant cheapness in the bond sector that enables Treasury to save significant money by buying them back.

Mr. NUSSLE. Thank you.

Mr. Rangel.

If there aren't any other members who wish to ask questions, thank you very much for your testimony and your attendance today; and with that, this hearing on the debt buyback proposal is adjourned.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

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